

# Chapter 15

## Financial Markets and Institutions

### ■ Learning Goals

1. Explain how financial institutions serve as intermediaries between investors and firms.
2. Provide an overview of financial markets.
3. Explain how firms and investors trade money market and capital market securities in the financial markets in order to satisfy their needs.
4. Describe the major securities exchanges.
5. Describe derivative securities and explain why they are used by firms and investors.
6. Describe the foreign exchange market.

### ■ Multiple Choice Questions

1. \_\_\_\_\_ serve as net suppliers of funds to financial institutions and \_\_\_\_\_ serve as net demanders of funds.
  - (a) Individuals; firms
  - (b) Firms; individuals
  - (c) Governments; firms
  - (d) Firms; governments

Answer: A

Level of Difficulty: 1

Learning Goal: 1

Topic:

2. Historically, \_\_\_\_\_ were the dominant direct lender to firms.
  - (a) mutual funds
  - (b) insurance companies
  - (c) commercial banks
  - (d) securities firms

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

3. Deposits at commercial banks are insured up to a maximum of \_\_\_\_\_.
- (a) \$20,000
  - (b) \$40,000
  - (c) \$100,000
  - (d) \$250,000

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

4. Which of the following is not a popular way by which commercial banks extend credit?
- (a) term loans
  - (b) certificates of deposit
  - (c) lines of credit
  - (d) investment in debt securities

Answer: B

Level of Difficulty: 2

Learning Goal: 1

Topic:

5. Which of the following is not a popular source of funds for commercial banks?
- (a) demand deposits (checking accounts)
  - (b) savings accounts
  - (c) lines of credit
  - (d) negotiable certificates of deposit

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

6. Which of these commercial banking activities was restricted by regulation until the late 1980s?
- (a) credit analysis
  - (b) the diversification of loans across individuals
  - (c) the placing of securities that are issued by firms
  - (d) the repackaging of deposits into loans

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

7. A \_\_\_\_\_ allows firms access to a specified amount of bank funds over a specified period of time.
- (a) line of credit
  - (b) term loan
  - (c) debt security
  - (d) savings account

Answer: A

Level of Difficulty: 1

Learning Goal: 1

Topic:

8. Until recently, which of the following financial intermediary activities was restricted from commercial banks?
- (a) diversification of loans across several borrowers
  - (b) credit analysis
  - (c) placing of securities issued by firms
  - (d) repackaging deposits as loans

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

9. The primary regulator of commercial banks in the United States is
- (a) The U.S. Department of the Treasury.
  - (b) The Federal Reserve System (FRS).
  - (c) The Federal Savings and Loan Insurance Corporation (FSLIC).
  - (d) The National Bank Chartering Agency (NBCA).

Answer: B

Level of Difficulty: 2

Learning Goal: 1

Topic:

10. Which of these is NOT one of the three broad categories of mutual funds as listed by your author.
- (a) stock mutual funds
  - (b) growth mutual funds
  - (c) bond mutual funds
  - (d) money market mutual funds

Answer: B

Level of Difficulty: 1

Learning Goal: 1

Topic:

11. Which of these is NOT a presumed advantage of owning a mutual fund over individual investments?
- (a) professional management
  - (b) portfolio diversification
  - (c) deposit insurance
  - (d) all of these are considered advantages to owning a mutual fund

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

12. \_\_\_\_\_ traditionally provide advice to firms, place securities (find buyers and sellers), and act as underwriters
- (a) Commercial banks
  - (b) Insurance companies
  - (c) Securities firms
  - (d) Mutual funds

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

13. Insurance companies are a category of firms referred to as
- (a) depository institutions.
  - (b) investment banks.
  - (c) investment companies.
  - (d) brokerage firms .
  - (e) none of the above.

Answer: E

Level of Difficulty: 1

Learning Goal: 1

Topic:

14. Insurance companies collect \_\_\_\_\_ and use the proceeds to purchase \_\_\_\_\_.
- (a) deposits; loans
  - (b) deposits; debt and equity securities
  - (c) premiums; debt and equity securities
  - (d) shares; loans

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

15. Pension funds receive payments called \_\_\_\_\_ from employees and/or their respective employers and invest the proceeds for the employees.

- (a) premiums
- (b) deposits
- (c) contributions
- (d) shares

Answer: C

Level of Difficulty: 1

Learning Goal: 1

Topic:

16. \_\_\_\_\_ often play a crucial role in facilitating the flow of funds from financial institutions to firms rather than actually providing the funds needed by firms.

- (a) Insurance companies
- (b) Securities firms
- (c) Commercial banks
- (d) Mutual funds

Answer: B

Level of Difficulty: 1

Learning Goal: 1

Topic:

17. In November 1999 President Clinton signed legislation repealing the Glass-Steagall Act. The Glass-Steagall Act was Depression Era legislation designed to

- (a) require the integration of investment banking and insurance activities.
- (b) encourage the chartering of state banks.
- (c) severely limit the amount of funds held by a single mutual fund.
- (d) separate commercial banking from investment banking activities.

Answer: D

Level of Difficulty: 2

Learning Goal: 1

Topic:

18. Citigroup Inc., which owns Citibank, Travelers' Insurance, and Salomon Smith Barney, is an example of a modern \_\_\_\_\_.

- (a) commercial bank
- (b) mutual fund
- (c) investment bank
- (d) insurance company
- (e) financial conglomerate

Answer: E

Level of Difficulty: 1

Learning Goal: 1

Topic:

19. Which of these was cited by the authors as a reason for the recent globalization of commercial banks?
- (a) the expansion of multinational corporations (MNCs)
  - (b) fewer restrictions placed on commercial banks outside the United States
  - (c) the establishment by banks of branch offices in foreign cities to capitalize on their global image
  - (d) all of the above
  - (e) none of the above

Answer: D

Level of Difficulty: 2

Learning Goal: 1

Topic:

20. A financial market in which pre-owned securities (those that are not new issues) are traded is known as a(n) \_\_\_\_\_.
- (a) secondary market
  - (b) primary market
  - (c) initial public offering
  - (d) money market

Answer: A

Level of Difficulty: 1

Learning Goal: 2

Topic:

21. A financial market in which securities are initially issued is known as a \_\_\_\_\_.
- (a) secondary market
  - (b) primary market
  - (c) money market
  - (d) capital market

Answer: B

Level of Difficulty: 1

Learning Goal: 2

Topic:

22. Springfield Hardware Inc. went public 5 years ago by issuing 1 million shares of stock for \$25 each. Last spring, to raise money for an expansion, they issued another 500,000 shares for \$50 each. Yesterday, 100,000 shares of Springfield stock was traded in the over-the-counter market with a closing price of \$55 per share. These transactions would be classified respectively as:
- (a) primary market activity; secondary market activity; an initial public offering
  - (b) secondary market activity; primary market activity; an initial public offering
  - (c) an initial public offering; secondary market activity; primary market activity
  - (d) an initial public offering; primary market activity; secondary market activity

Answer: D

Level of Difficulty: 2

Learning Goal: 2

Topic:

23. Which of the following is NOT an advantage of a public offering conducted by a securities firm versus a private placement of securities?
- (a) advice about the size of the offering
  - (b) advice about the price of the offering
  - (c) underwriting services
  - (d) avoidance of fees and transaction costs

Answer: D

Level of Difficulty: 1

Learning Goal: 2

Topic:

24. A(n) \_\_\_\_\_ is the sale of new securities directly to an investor or group of investors.
- (a) public offering
  - (b) corporate bond
  - (c) private placement
  - (d) underwritten security

Answer: C

Level of Difficulty: 1

Learning Goal: 2

Topic:

25. Financial instruments that are characterized as being low-risk, highly liquid, and short-term are known as \_\_\_\_\_.
- (a) capital market securities
  - (b) bonds
  - (c) stocks
  - (d) money market securities

Answer: D

Level of Difficulty: 1

Learning Goal: 3

Topic:

26. Short-term debt securities issued by the U.S. Treasury are known as
- (a) Treasury Bonds
  - (b) Treasury Bills
  - (c) Treasury Notes
  - (d) Series EE Savings Bonds

Answer: B

Level of Difficulty: 1

Learning Goal: 3

Topic:

27. The amount to be paid at maturity for debt securities is known as the \_\_\_\_\_.
- (a) interest
  - (b) discount
  - (c) par value
  - (d) premium

Answer: C

Level of Difficulty: 1

Learning Goal: 3

Topic:

28. The minimum par value on Treasury bills is \_\_\_\_\_.
- (a) \$1,000
  - (b) \$10,000
  - (c) \$100,000
  - (d) \$1,000,000

Answer: B

Level of Difficulty: 1

Learning Goal: 3

Topic:

29. Carbondale Co. bought a one-year \$100,000 par value Treasury bill for \$93,500. If Carbondale holds the bill to maturity, what will be the one-year rate of return?
- (a) 6.50%
  - (b) 6.95%
  - (c) 7.45%
  - (d) not enough information to answer the question

Answer: B

Level of Difficulty: 2

Learning Goal: 3

Topic:

30. The Gypsum Company purchased a one-year Treasury bond at a price of \$9,450 and sold it four (4) months later for \$9,700. Its approximate annualized rate of return was \_\_\_\_\_.
- (a) 2.50%
  - (b) 2.65%
  - (c) 8.00%
  - (d) 10.70%

Answer: C

Level of Difficulty: 2

Learning Goal: 3

Topic:



31. A \_\_\_\_\_ is a bond issued in a foreign country but denominated in the issuer's domestic currency, and a \_\_\_\_\_ is a bond issued in a foreign country and denominated in the foreign currency.
- (a) foreign bond; eurobond
  - (b) eurobond; foreign bond
  - (c) eurobond; eurobond
  - (d) foreign bond; foreign bond

Answer: B

Level of Difficulty: 2

Learning Goal: 3

Topic:

32. \_\_\_\_\_ is a short-term debt security issued by well-known credit worthy firms.
- (a) A negotiable certificate of deposit
  - (b) Commercial paper
  - (c) Commercial debt
  - (d) Common stock

Answer: B

Level of Difficulty: 1

Learning Goal: 3

Topic:

33. Which of the following money market instruments pay coupon interest payments?
- (a) treasury bills
  - (b) commercial paper
  - (c) negotiable certificates of deposit
  - (d) bankers acceptances

Answer: C

Level of Difficulty: 1

Learning Goal: 3

Topic:

34. Which financial instrument might firms use as an alternative to or a substitute for a short-term bank loan?
- (a) treasury bills
  - (b) certificates of deposit
  - (c) money market mutual fund
  - (d) commercial paper

Answer: D

Level of Difficulty: 1

Learning Goal: 3

Topic:

35. When investing in a foreign security investors bear \_\_\_\_\_. Specifically, the risk that the foreign currency will \_\_\_\_\_ while held.
- (a) default risk; strengthen
  - (b) exchange rate risk; strengthen
  - (c) exchange rate risk; weaken
  - (d) interest rate risk; weaken

Answer: C

Level of Difficulty: 2

Learning Goal: 3

Topic:

36. Money market securities that do not pay coupon interest payments are said to
- (a) be issued at a premium.
  - (b) be issued at a discount.
  - (c) be issued on the cheap.
  - (d) have no value until maturity.

Answer: B

Level of Difficulty: 1

Learning Goal: 3

Topic:

37. The minimum denomination for U.S. Treasury bonds is \_\_\_\_\_.
- (a) \$1,000
  - (b) \$10,000
  - (c) \$100,000
  - (d) \$1,000,000

Answer: A

Level of Difficulty: 1

Learning Goal: 3

Topic:

38. Which of the following is NOT true about U.S. Treasury bonds?
- (a) semi-annual interest payments
  - (b) an inactive secondary market
  - (c) maturities of 10 to 30 years
  - (d) free of default risk

Answer: B

Level of Difficulty: 1

Learning Goal: 3

Topic:

39. A Treasury bond with a par value of \$100,000 and a current price of \$95,000 pays coupon interest payments of
- (a) \$5,000 per year.
  - (b) \$2,500 every six months.
  - (c) \$5,000 every six months.
  - (d) not enough information to answer this question.

Answer: D

Level of Difficulty: 1

Learning Goal: 3

Topic:

40. The two types of municipal bonds are
- (a) general obligation bonds and municipal bonds.
  - (b) general obligation bonds and agency bonds.
  - (c) general obligation bonds and revenue bonds.
  - (d) agency bonds and revenue bonds.

Answer: C

Level of Difficulty: 1

Learning Goal: 3

Topic:

41. The interest income from Treasury bonds is
- (a) taxable as ordinary income for both federal and state income tax purposes.
  - (b) exempt from federal income taxes.
  - (c) exempt from state and local income taxes.
  - (d) exempt from federal, state and local income taxes.

Answer: C

Level of Difficulty: 2

Learning Goal: 3

Topic:

42. The interest income from municipal bonds
- (a) is taxable as ordinary income for both federal and state income tax returns.
  - (b) is exempt from federal income taxes.
  - (c) is exempt from state and local income taxes.
  - (d) is exempt from federal taxes and may be exempt from state and local income taxes.

Answer: D

Level of Difficulty: 2

Learning Goal: 3

Topic:

43. Valley Industries has just issued a \$1,000 par value, 10% coupon bond payable semi-annually, with a maturity of 20 years. What must be true for Valley Industry bondholders?
- (a) They should receive annual end-of the year payments of \$100.
  - (b) They should receive a \$500 principal payment in year 10 and the remaining \$500 principal payment in year 20.
  - (c) They are entitled to receive interest only on this bond.
  - (d) They should receive \$50 every six months for the next 20 years plus the \$1000 par value in year 20.

Answer: D

Level of Difficulty: 2

Learning Goal: 3

Topic:

44. Coca-Cola Inc. wishes to fund a European subsidiary. Which of the funding opportunities is not available to Coke?
- (a) Issue bonds in the United States and use the proceeds to fund the European subsidiary
  - (b) Issue bonds in Europe denominated in the Euro
  - (c) Issue bonds in Europe denominated in dollars
  - (d) All of these opportunities are available to Coke

Answer: D

Level of Difficulty: 1

Learning Goal: 3

Topic:

45. Which of the following are TRUE regarding preferred stock?
- (a) Common stock has priority over preferred stock when receiving dividends
  - (b) Preferred stock is promised a fixed dividend payment
  - (c) Preferred stock dividends are tax deductible for corporations
  - (d) All of these are true regarding preferred stock

Answer: B

Level of Difficulty: 1

Learning Goal: 3

Topic:

46. An investor could choose to diversify internationally by
- (a) investing in a multinational corporation.
  - (b) directly investing in foreign securities.
  - (c) purchasing shares of an international mutual fund.
  - (d) all of the above.

Answer: D

Level of Difficulty: 1

Learning Goal: 3

Topic:

47. The two key type of securities exchanges are
- (a) the money market and the capital market.
  - (b) the primary market and the secondary market.
  - (c) the options market and the stock market.
  - (d) the organized exchange and the over-the-counter market.

Answer: D

Level of Difficulty: 1

Learning Goal: 4

Topic:

48. The largest and best known security exchange is the
- (a) American Stock Exchange (ASE).
  - (b) Chicago Board of Trade (CBOT).
  - (c) Pacific Stock Exchange (PSE).
  - (d) New York Stock Exchange (NYSE).

Answer: D

Level of Difficulty: 1

Learning Goal: 4

Topic:

49. The \_\_\_\_\_ is the highest price offered by a dealer to purchase a given security and the \_\_\_\_\_ is the lowest price at which the dealer is willing to sell the security.
- (a) ask price; ask price
  - (b) ask price; bid price
  - (c) bid price; ask price
  - (d) bid price; bid price

Answer: C

Level of Difficulty: 1

Learning Goal: 4

Topic:

50. Which of the following is an example of a derivative security?
- (a) stocks
  - (b) options
  - (c) bonds
  - (d) mutual funds

Answer: B

Level of Difficulty: 1

Learning Goal: 5

Topic:

51. Investment in a derivative security can increase risk if it is a \_\_\_\_\_ or reduce risk if it is a \_\_\_\_\_.
- (a) speculative investment; hedged position
  - (b) speculative investment; speculative investment
  - (c) hedged position; hedged position
  - (d) hedged position; speculative investment

Answer: A

Level of Difficulty: 1

Learning Goal: 5

Topic:

52. The foreign exchange market
- (a) is located exclusively in London.
  - (b) is organized by the Central Bank of England.
  - (c) facilitates the purchase and sale of foreign securities.
  - (d) is all of the above.

Answer: C

Level of Difficulty: 1

Learning Goal: 6

Topic:

53. The market that facilitates foreign exchange transactions that involve immediate exchange of currencies is known as \_\_\_\_\_.
- (a) the money market
  - (b) the spot market
  - (c) the forward market
  - (d) the capital market

Answer: B

Level of Difficulty: 1

Learning Goal: 6

Topic:

54. An agreement that specifies the amount of a specific currency that will be exchanged, the exchange rate, and the future date at which a currency exchange will occur is known as
- (a) a forward market.
  - (b) a forward rate.
  - (c) a forward contract.
  - (d) the foreign exchange market.

Answer: C

Level of Difficulty: 1

Learning Goal: 6

Topic:

55. When a firm expects to need a foreign currency in the future, it can engage in a forward contract
- (a) to buy the currency forward.
  - (b) to sell the currency forward.
  - (c) to either buy or sell the currency forward.
  - (d) but would always prefer to use the spot market in the future.

Answer: A

Level of Difficulty: 3

Learning Goal: 6

Topic:

56. Post World War Two (1944–1971) was characterized by a regime of \_\_\_\_\_ exchange rates during the so-called \_\_\_\_\_ Era.
- (a) floating; Smithsonian
  - (b) fixed; Smithsonian
  - (c) floating; Bretton Woods
  - (d) fixed; Bretton Woods

Answer: D

Level of Difficulty: 1

Learning Goal: 6

Topic:

57. A firm's first offering to the public is known as
- (a) an initial public offering.
  - (b) a secondary offering.
  - (c) a public offering.
  - (d) a private placement.

Answer: A

Level of Difficulty: 1

Learning Goal: 4

Topic:

58. A bond that is backed by a municipality's ability to tax is a \_\_\_\_\_.
- (a) revenue bond
  - (b) agency bond
  - (c) general obligation bond
  - (d) treasury bond

Answer: C

Level of Difficulty: 1

Learning Goal: 3

Topic:

59. \_\_\_\_\_ pool funds from savers and make them available to business and government demanders. They obtain funds through the sale of shares and use the proceeds to acquire bonds and stocks.

- (a) Savings institutions
- (b) Credit unions
- (c) Pension funds
- (d) Mutual funds

Answer: D

Level of Difficulty: 1

Learning Goal: 3

Topic:

60. \_\_\_\_\_ provide financing to firms by receiving employee contributions and using those contributions to purchase firm debt and equity securities.

- (a) Commercial banks
- (b) Pension funds
- (c) Mutual funds
- (d) Insurance companies

Answer: B

Level of Difficulty: 1

Learning Goal: 3

Topic:

## ■ Short-Answer Questions and Problems

1. Individuals are net suppliers of funds to financial institutions and businesses are net borrowers. Identify several ways individuals supply funds and businesses borrow funds.

**Answer:** Individuals supply funds via savings and demand deposits and buying CDs at commercial banks and savings institutions. They buy shares in mutual funds, make contributions to pension funds, pay premiums to insurance companies, and use securities firms to purchase stocks and bonds. Businesses borrow money from commercial banks via loans and lines-of-credit. They borrow money by issuing commercial paper or selling debt. Businesses also utilize securities firms to sell preferred and common stock.

2. What is the general philosophy of regulators who monitor the commercial banking system today?

**Answer:** Regulators want to promote competition among banks and to also maintain stability. The promotion of competition is seen in such laws as the Gramm-Leach-Bliley Act of 1999. This law significantly reduces the barriers between insurance companies, securities firms, and commercial banks by allowing each to enter the other's traditional markets. Regulators hope that such competition will increase market efficiency, reduce costs, and spawn new products at a faster rate. Regulators are also charged with maintaining the safety, soundness, and stability of the banking system. Thus, they provide deposit insurance, require banks to maintain deposit reserves, and charge deposit insurance premiums based roughly on the riskiness of the bank's portfolio. Regulators also act as a lender of last resort to help maintain confidence in the financial system.



3. Provide a list of several types of financial securities and the financial institutions that supply them if you needed to provide money for:

- A down payment in six months on your first house
- The purchase in five years of a new car
- Your children beginning college fifteen years from today

**Answer:** First house in six months is a short time period so I would choose savings deposits at a commercial bank or savings institution. I might also choose to buy a CD from a bank or securities firm, a Treasury bill, or a money market mutual fund (MMMF). These investment choices all have short-term time horizons, are low to no risk, and are very liquid.

The new car purchase is of an intermediate time horizon so I can be less concerned about liquidity and more concerned about return. Longer term CDs from banks or securities firms, intermediate maturity bonds or notes, and equity securities, are candidates for the new car purchase. I may choose each or all three, or perhaps a mutual fund that invests in all three.

The college education has the longest time horizon, thus I can invest in capital market securities that have greater risk and greater expected return. I would turn to a securities firm to purchase individual stocks and bonds, or to a mutual fund that matches my objectives.

4. How will the consolidation and globalization of financial intermediaries affect the way financial managers and individuals interact with the financial system?

**Answer:** There are several good answers to this question. Ideas might include one-stop shopping for all of your financial needs from raising long-term or short-term funds, to investing excess funds, to getting financial advice, to gathering information, to making payments, to managing pension funds, obtaining insurance, or exchanging currencies (here or abroad). One bookmarked Internet address may allow you to complete several financial transactions at one time in one place, saving you time and money and making for greater efficiencies in the financial markets.

5. List three money market instruments. What characteristics do they have in common? How are they different?

**Answer:** Treasury bills, commercial paper (CP), and negotiable certificates of deposit (CDs) are the three money market instruments most prominently featured in the chapter. All three are short-term, low-risk, highly liquid securities. T-bills are government securities, firms issue CP, and banks typically issue CDs. T-bills and CP are sold at a discount, CDs pay interest in excess of par value. T-bills trade in minimums of \$10,000, the minimum for CDs and CP is \$100,000. T-bills are exempt from state taxes the others are not.

6. Why is the required return on a municipal bond lower than the required return on a corporate bond of similar risk and maturity?

**Answer:** Municipal bonds are exempt from federal and often state and local taxes. Investors make decisions based on after-tax cash flows. Because the municipal bonds are either taxed at a lower rate or not taxed at all, they require fewer before-tax cash flows to result in the same after-tax cash flow of equivalent corporate bonds.

7. Your firm just landed a big contract to sell footballs in London. The footballs will be shipped in 30 days and you will be paid in British pounds in 90 days. How could you use the spot market for the exchange of currency to complete this transaction? How could you use the forward market for the exchange of currency to complete this transaction? Which would you prefer? Why?

**Answer:** You could wait for 90 days to trade your pounds for dollars at the then prevailing spot rate. The risk is you don't know what the pounds will be worth. Essentially, you won't know what you sold the footballs for until you exchange the pounds for dollars in 90 days. You could enter into a forward contract today and agree to sell the pounds for a specific amount of dollars in 90 days. The advantage here is you know today exactly how many dollars you will receive in 90 days. The forward hedge reduces uncertainty and, if reasonably priced, would be my choice.

8. Explain the difference between an organized securities exchange and an over-the-counter market.

**Answer:** Organized exchanges have an actual physical location where trading through brokers takes place. The OTC does not have a physical trading floor, rather, trades take place through a network of dealers willing to buy and sell securities.

9. What are some key advantages to a firm for making a private placement instead of a public offering?

**Answer:** The private placement avoids fees charged by securities firms. It may also place the debt or equity into the hands of investors sympathetic to existing management.

10. Exchange rates were essentially fixed after WWII until the 1970s when they were allowed to float or vary with other currencies and subject to the market forces of supply and demand. What are the perceived advantages and disadvantages of a rate system with floating exchange rates?

**Answer:** A floating rate system introduces exchange rate risk into the equation for international trade. The increased risk decreases the amount of trade because it adds uncertainty to the value of international contracts. On the other hand, unless currency exchange rates are allowed to adjust to market forces, those currencies that are priced too high will not be purchased, and those priced too low will suffer from excess demand. Thus trade can be reduced due to a lack of interest for a particular type of currency.