

# **Testbank**

to accompany

# **Financial Markets, Institutions & Money 3<sup>rd</sup> edition**

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# **WILEY**

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## Chapter 1: Overview

### True False Questions

1. One role of the financial system is to transmit information between savers and borrowers.
  - a. True
  - b. False

*Correct answer: b*

2. A surplus spending unit is an economic unit whose income in a period exceeds planned expenditure.
  - a. True
  - b. False

*Correct answer: a*

3. A major role of the financial system is to channel funds from surplus spending units to deficit spending units. 资金流动
  - a. True
  - b. False

*Correct answer: a*

4. IOUs are financial claims against someone else's money at a future date.
  - a. True
  - b. False

*Correct answer: a*

5. A payment system is a system that permits the settlement of commercial and financial transactions.
  - a. True
  - b. False

*Correct answer: a*

6. Information asymmetry means that  contracting parties have incomplete access to some relevant information.
- a. True
  - b. False

*Correct answer: b*

7. Adverse selection is present in a market when the contracting parties have asymmetric information and the less informed party bears negative consequences.
- a. True
  - b. False

*Correct answer: a*

8. Direct finance requires an  match of preferences in terms of investment horizon between surplus spending units and deficit spending units. 太绝对 more or less
- a. True
  - b. False

*Correct answer: b*

9. Liabilities of financial intermediaries are indirect financial claims.
- a. True
  - b. False

*Correct answer: a*

10. Equity funds are funds supplied in the . Debt funds
- a. True
  - b. False

*Correct answer: b*

11. In direct finance DSUs and SSUs trade with each other directly without middlemen.
- a. True
  - b. False

*Correct answer: b*

12. Commercial banks' lending to businesses is a form of indirect finance.

- a. True
- b. False

*Correct answer: a*

13. The underwriting spread 包销差价 is the profit that a dealer is willing to make when buying and selling financial securities in an over-the-counter market.

- a. True
- b. False

*Correct answer: b*

14. Brokers 'make a market' by managing an inventory of financial securities.

- a. True
- b. False

*Correct answer: b*

15. Building societies and credit unions are a type a commercial banks.

- a. True
- b. False

*Correct answer: b*

16. Managed funds are a type of authorised deposit-taking institutions. Financial institution 非 bank 非 nonbank 的 intermediary

- a. True
- b. False

*Correct answer: b*

17. Superannuation funds are also known as credit unions. Financial institution 非 bank 非 nonbank 的 intermediary; 而 credit union 是 nonbank financial corporation

- a. True
- b. False

*Correct answer: b*

18. Secondary markets provide funds to deficit spending units. **Liquidity**

- a. True
- b. False

*Correct answer: b*

19. Primary markets offer liquidity and ways for investors to alter the risk of their portfolios. **Primary 只 sell**

- a. True
- b. False

*Correct answer: b*

20. The Australian Securities Exchange (ASX) is an example of an organised secondary market.

- a. True
- b. False

*Correct answer: a*

**21.** Money markets are over-the-counter markets, and therefore have no specific location.

- a. True
- b. False

*Correct answer: a*

22. In the money market, companies and governments manage their liquidity position.

- a. True
- b. False

*Correct answer: a*

**23.** Commercial paper has an active secondary market. **Money market instrument**

- a. True
- b. False

*Correct answer: b*

24. The stock of Australian long-term debt securities includes shares.

- a. True
- b. False

*Correct answer: b*

25. The risk that a financial institution may be unable to generate sufficient cash inflow to meet required cash outflows is called an operational risk.

- a. True
- b. False

*Correct answer: b*

## Multiple Choice Questions

26. The functions of a financial system include
- a. facilitating the flow of funds.
  - b. providing the mechanism for the settlement of transactions.
  - c. providing means for the transfer and management of risks.
  - d. all of the above.

*Correct answer: d*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole.*

*Feedback: The flow of funds refers to the channelling of funds from the units with financial surplus to units with financial deficit, either directly or through financial intermediaries. The settlement function is fulfilled by the payment system, which is part of the financial system. The financial system, through general insurance companies or life insurance companies, provide ways to alleviate risks. In addition the financial system provides means for insuring against the risks created by some financial claims. The list of functions could be completed with the following ones: “generating and disseminating information that assists decision making” and “providing ways of dealing with the incentive problems that arise in financial contracting”.*

27. A deficit spending unit is an economic unit
- a. whose planned expenditure in a period exceeds current income.
  - b. who can provide funds to the financial system.
  - c. who has negative income.
  - d. whose income is less than planned saving.

*Correct answer: a*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole.*

*Feedback: In order to provide funds to the financial system, the economic unit needs to be a surplus spending unit (SSU), i.e. its income exceeds planned expenditure so there are funds left (called savings). The SSU may also decide to repay existing debt instead of acquiring new financial assets. The deficit spending unit (DSU) is in the opposite situation as planned expenditure exceeds income (negative savings) and therefore he/she needs to find funds in the financial system to pay for the expenditure as an alternative to liquidate existing assets.*

28. Which of the following statements is NOT correct?  
The financial system facilitates the flow of funds

- a. from savers to 'borrowers'.
- b. from SSUs to DSUs.
- c. from savers to deficit spending units.
- d. from 'borrowers' to savers.

*Correct answer: d*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole.*

*Feedback: Savers/SSU/surplus spending units represent the same side of the funds channelling, i.e. the providers of funds. Borrowers/DSU/deficit spending units on the other hand represent the recipients of funds. The term 'borrowers' stricto sensu refers to the case where the financial claim is a debt, i.e. the funds provided need to be repaid. The DSU may choose rather to issue a share (not a debt) that entitles the provider of funds to a part of future profit. In that case the term "borrower" is not exactly correct as no repayment is required, hence the use of quotes in the question.*

29. Which of the following statements is NOT correct?  
Financial claims that take the form of debt are

- a. IOUs.
- b. written promises to pay a specific sum of money (the principal) plus interest for the privilege of borrowing money over a period of time.
- c. issued by borrowers and purchased by providers of funds.
- d. equity for recipients of funds and assets for providers of funds.

*Correct answer: d*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

*Feedback: Debt means that the funds need to be repaid back to the provider of funds at a later date. IOU (=I owe you) / principal plus interests/ liability are all concepts that relate to debt. If the financial claim takes the form of a share then it is not a debt because the recipient of funds will not pay back the funds but will pay dividends (from the company's profits) to the shareholders for as long as the company exists. Issued shares appear as equity in the balance sheets of the recipient of funds, not as liability like a debt.*



30. Which of the following statements best describes the concept of "two faces of debt"?
- a. DSUs in one period can be SSUs in another one.
  - b. Every financial asset is someone else's liability/equity.
  - c. Intermediaries issue financial claims to SSUs and own financial claims issued by DSUs.
  - d. Government debt requires higher taxation in the future to repay the principal and interests of the debt.

*Correct answer: b*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

*Feedback: Financial claims are liabilities (if debt) or equity (if shares) for recipients of funds and are assets to providers of funds. All the other statements are correct but are not related to the concept of "two faces of debt".*

31. Information asymmetry in a debt contract occurs when
- a. the financial market is imperfect.
  - b. borrowers provide complete information to the lenders.
  - c. the lender who holds the IOU shares the same information as the borrower.
  - d. one party to the contract has access to more or better information than the other party.

*Correct answer: d*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

*Feedback: Asymmetric information occurs when the contracting parties do not have equal access to relevant information and therefore one party is at an advantage. For example, a prospective borrower is likely to know more about their capacity to repay and intended use of the borrowed funds than the lender.*

32. 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 costs are low.
  - d. lenders have a limited choice of financial investments.

*Correct answer: c*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

33. The ability to resell financial claims in a secondary market is important because it allows 因为可以慢慢还?
- a. DSUs to finance a project with successive issues of financial claims.
  - b. SSUs to purchase financial claims with maturities that are longer than their investment horizon.
  - c. SSUs to purchase financial claims with maturities that are shorter than their investment horizon.
  - d. DSUs to implement projects with horizon shorter than the SSUs' investment horizon.

*Correct answer: b*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

34. The financial system facilitates the flow of funds
- a. from savers to units whose planned expenditure exceeds income.
  - b. from DSUs to SSUs.
  - c. from units whose income is less than planned expenditure to deficit spending units.
  - d. None of the above.

*Correct answer: a*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

35. The functions of the financial system include:
- a. facilitating the flow of funds.
  - b. providing ways of dealing with the incentive problems that arise in financial contracting.
  - c. generating and disseminating information that assists decision making.
  - d. all of the above.

*Correct answer: d*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

36. Financial claims are
- a. issued by the providers of funds.
  - b. assets for the recipients of funds.
  - c. held by the providers of funds.
  - d. exchanged for a financial security.

*Correct answer: c*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

37. An effective payments system is characterised by its efficiency in terms of
- a. speed, cost and stability.
  - b. the financial strength of the financial institutions (including the central bank).
  - c. the settlement mechanism for transferring funds among financial institutions.
  - d. all of the above.

*Correct answer: d*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

38. Information asymmetry occurs when
- a. one contracting party has a better knowledge than the other party and therefore is at an advantage.
  - b. there is separation between ownership and control of firms.
  - c. one contracting party can change behaviour to the detriment of the other party.
  - d. when the interests of the contracting parties are not aligned.

*Correct answer: a*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

39. Which of the following are NOT financial claims?
- a. bonds.
  - b. shares.
  - c. loans.
  - d. commodities. 商品

*Correct answer: d*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

40. Moral hazard is
- a risk resulting from adverse selection.
  - the risk that managers may not act in the interest of shareholders.
  - the risk that one party to a contract may change its behaviour to the detriment of the other party once a contract has been signed.
  - a type of default risk.

*Correct answer: c*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

41. During 2013, John and Mary Smith expect total income of about \$225,000 and are budgeting total expenditure of about \$180,000. For this budget period, the Smith family is most specifically a
- deficit spending unit.
  - a recipient of funds from the financial system.
  - surplus spending unit.
  - financial intermediary.

*Correct answer: c*

*Learning Objective 1.1 ~ Explain the role of the financial system and why it is important to individuals and to the economy as a whole*

42. Which of the following situations is an example of indirect finance?  
A DSU issues a financial claim that is bought by
- a SSU in the primary market.
  - a SSU through a dealer in the secondary market.
  - a superannuation fund with the funds provided by SSUs.
  - a SSU through an underwriter in the primary market.

*Correct answer: c*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

*Feedback: The main aspect of indirect finance is that the SSU does not hold/own the financial claim issued by the DSU. The SSU instead holds a claim issued by a financial institution that will use the SSU's funds to purchase the financial claim issued by the DSU. Using an underwriter or a dealer is irrelevant to decide whether the financing is direct or indirect as underwriters and dealers' role is simply to assist with the transfer of the financial claims between the two parties involved regardless of who these parties are. Dealers and brokers are involved between DSU and SSU if direct finance, but are involved between DSU and financial intermediary and between financial intermediary and SSU if indirect finance.*

43. Which of the following is NOT a comparative advantage of financial intermediaries over surplus spending units in providing funds to deficit spending units?
- a. Higher searching costs for credit information
  - b. Economies of scale
  - c. Better management of credit risk
  - d. Lower transactions costs

*Correct answer: a*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

*Feedback: Financial intermediaries transform claims: the claims that link them to SSUs are different to the claims that link them to DSUs. Thanks to that differentiation financial intermediaries can reach a better outcome than what SSUs could do directly. Financial intermediaries are able to generate a profit out of this transformation because: (a) of economies of scale of production, (b) they reduce search costs for both DSUs and SSUs, and (c) they are able to obtain sensitive information, which allows them to manage credit risk better.*

44. Denomination transformation refers to the ability of financial institutions to
- a. raise short-term funds to lend for longer periods.
  - b. raise funds in one currency to lend in another currency.
  - c. raise many small amounts to lend larger amounts.
  - d. spread risk.

*Correct answer: c*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

*Feedback: The denomination is the amount of money lent associated to a given financial claim. Surplus spending units usually can provide only small amounts of funds while deficit spending units have often very large needs. Financial intermediaries can reconcile these opposite preferences. The other answers are related to other services provided by financial institutions. Raising short-term funds to lend for longer periods is called maturity transformation. Raising funds in one currency to lend funds in another currency is currency transformation. Spreading risks refers to risk diversification.*

45. Direct finance is involved when households
- a. buy commercial banks' shares.
  - b. deposit funds in a building society.
  - c. buy government bonds.
  - d. buy managed funds' shares.

*Correct answer: c*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

*Feedback: Direct financing involves DSUs issue financial claims and sell them for money to SSUs likely with the assistance of underwriters and dealers. When households provide funds to managed funds and building society, this type of financing is not direct finance because managed funds and building societies are not DSUs. They do not issue financial claims because they have an income smaller than their expenditures but they raise funds from the financial system because they want to invest in financial claims.*

46. Which of the following does NOT relate to a dealer's job? 经销商
- a. Providing liquidity to sellers of securities.
  - b. Buying and selling from an inventory of securities.
  - c. Earning return from bid-ask spread.
  - d. Transforming financial claims.

*Correct answer: d*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

*Feedback: Financial intermediaries buy financial claims with one set of characteristics from DSUs, and then issue their own liabilities/equity with different characteristics to SSUs. Thus, financial intermediaries "transform" claims to make them more attractive to both DSUs and SSUs. Dealers are not financial intermediaries as they simply facilitate the transfer of financial claims in the secondary market. The financial claims the dealer trades appear as an asset in its balance sheet. The financial claims inventory on the asset side decreases when the dealer sells the securities and increases when the dealer buys the securities.*

47. Which of the following is an example of indirect finance?  
A SSU purchases a financial claim issued by
- a. a DSU from an investment bank.
  - b. a DSU from a dealer.
  - c. a commercial bank.
  - d. a DSU from an underwriter.

*Correct answer: c*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

48. A dealer offers to buy IBM bonds at \$125 and sell to investors at \$127. The bid price is 买价

- a. \$125.
- b. \$127.
- c. \$2.
- d. -\$2.

Correct answer: a

Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries

49. Most financial intermediaries issue \_\_\_\_\_ financial claims and purchase \_\_\_\_\_ financial claims.

- a. direct; direct
- b. indirect; indirect
- c. direct; indirect
- d. indirect; direct

Correct answer: d

Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries

50. Direct finance is best exemplified by

- a. households purchasing managed fund shares.
- b. households depositing funds in a credit union.
- c. households buying non-financial companies shares.
- d. employees contributing to a superannuation fund.

Correct answer: c

Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries

51. A sale of an entire security issue to one surplus spending unit or a small group of surplus spending units is

- a. a dealer arrangement.
- b. a private placement. 私人配售
- c. an underwriting. 认购
- d. indirect finance.

Correct answer: b

Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries

## 52. Dealers

- a. earn commissions. –brokers
- b. earn the bid-ask spread.
- c. facilitate the issue of financial claims among investors.
- d. underwrite new issues of securities.

*Correct answer: b*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

## 53. XX Securities holds an inventory of A&amp;P Corp. stock, buying at \$65.00 and selling at \$67.50. The bid price is \_\_\_\_\_; the bid-ask spread is \_\_\_\_\_.

- a. \$65.00; \$2.50
- b. \$67.50; \$2.50
- c. \$67.50; -\$2.50
- d. \$65.00; -\$2.50

*Correct answer: a*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

## 54. The \_\_\_\_\_ price is the highest price offered by a dealer to sell a given security.

- a. market
- b. ask
- c. offering
- d. bid

*Correct answer: b*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

## 55. Credit risk diversification of a loan portfolio 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. loans with similar payment patterns are combined in a single portfolio.

*Correct answer: c*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*



56. Which of the following is NOT a comparative advantage of financial intermediaries over surplus spending funds in providing funds to deficit spending units?
- a. Ability to increase credit risk
  - b. Ability to achieve economies of scale
  - c. Ability to reduce transaction costs
  - d. Ability to find confidential information

*Correct answer: a*

*Learning Objective 1.2 ~ Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries*

57. Which of the following financial institutions accepts deposits as liabilities?
- a. Managed fund
  - b. Superannuation fund
  - c. Credit union
  - d. Finance company do not take...

*Correct answer: c*

*Learning Objective 1.3 ~ Describe the different types of financial intermediaries*

*Feedback: Credit unions and building societies are not commercial banks but accept deposits in their liabilities, like commercial banks. Finance companies do not take deposits and resort to the issue of short term debt to finance their loans. Superannuation funds collect funds through the contributions of employees and employers while managed funds raise funds through the issue of shares.*

58. Which of the following financial institutions have loans as assets?
- a. Managed funds
  - b. Superannuation funds
  - c. Life insurance companies
  - d. Finance companies

*Correct answer: d*

*Learning Objective 1.3 ~ Describe the different types of financial intermediaries*

*Feedback: Managed funds, superannuation funds and life insurance companies provide funds to the financial system when they purchase securities in the primary or secondary markets. However they do not make loans, which are non-standardised contracts tailored by the lender to the needs of the borrowers. Finance companies, like commercial banks, building societies and credit unions, make loans. However finance companies, unlike banks, building societies and credit unions, exclusively issue securities to fund their loans, while the other institutions have deposits as a major component of their liabilities.*

59. Superannuation funds tend to invest in
- a. long-term securities predominantly.
  - b. money market securities exclusively.
  - c. government securities exclusively.
  - d. lower-yielding securities predominantly.

*Correct answer: a*

*Learning Objective 1.3 ~ Describe the different types of financial intermediaries*

60. Which of the following activities is NOT performed by money-market corporations?
- a. Offering insurance services
  - b. Marketing new issues of securities
  - c. Underwriting securities
  - d. Advising on mergers and acquisitions

*Correct answer: a*

*Learning Objective 1.3 ~ Describe the different types of financial intermediaries*

61. Which of the following financial institutions does NOT accept deposits as liabilities?
- a. Commercial bank
  - b. Building society
  - c. Credit union
  - d. Finance company

*Correct answer: d*

*Learning Objective 1.3 ~ Describe the different types of financial intermediaries*

62. Managed funds
- a. issue bonds and shares to raise funds.
  - b. allow small investors to get the benefits of economies of scale.
  - c. make loans to businesses and households.
  - d. diversify their activities over several sectors of the economy, over several parts of the world and over several types of financial instruments.

*Correct answer: b*

*Learning Objective 1.3 ~ Describe the different types of financial intermediaries*

63. General insurance companies

- a. get funds through the collection of premiums from policyholders.
- b. provide income at the death of the policyholders.
- c. invest primarily in high-yield long-term assets.
- d. provide a regular income to policyholders.

*Correct answer: a*

*Learning Objective 1.3 ~ Describe the different types of financial intermediaries*

64. Which of the following statements is NOT correct?  
Australian commercial banks

- a. have various sources of funds.
- b. take deposits and make loans.
- c. have fewer assets than superannuation funds.
- d. are highly regulated.

*Correct answer: c*

*Learning Objective 1.3 ~ Describe the different types of financial intermediaries*

65. An over-the-counter market

- a. allows investors in financial claims to trade directly among themselves.
- b. has no central location.
- c. is a primary market.
- d. is regulated by the RBA.

*Correct answer: b*

*Learning Objective 1.4 ~ Describe the various types of financial markets*

*Feedback: An organised security exchange has a central location whereas an over-the-counter market operates through a network of dealers located at various locations.*

*Organised security exchanges and over-the-counter markets are secondary markets as their purpose is to assist in the change of ownership among investors over financial claims. Trade in the secondary market does not involve the issuer, except in the rare case of buybacks. All markets are regulated by ASIC, while the RBA focuses on the general stability of the financial system. Investors in an over-the-counter market trade with a dealer not with each other.*

66. Which of the following transactions belongs to the primary market?
- a. A managed fund sells some Telstra shares it owns.
  - b. Mrs Brown buys Rio Tinto shares in ASX.
  - c. The Federal government sells Treasury bonds to finance road infrastructure.
  - d. Mr Jones sells government bonds to a dealer.

*Correct answer: c*

*Learning Objective 1.4 ~ Describe the various types of financial markets*

*Feedback: A primary market is the market in which financial claims are sold for the first time in order to provide funds to the issuer of the claim. When the government puts in circulation new Treasury bonds with the aim of raising funds, this transaction takes place in the primary market. The later transactions among investors who want to rearrange their portfolios will take place in the secondary market. When an investor sells an asset it had previously bought the transaction is necessarily in the secondary market and the transaction brings funds to the selling investor not the issuer of the financial claim. The managed funds selling Telstra shares and Mr Jones selling the government bonds are good examples of investors trading in the secondary market. ASX, where shares trade among investors, is a famous example of a secondary market. New shares issued by corporations to raise funds are not put in circulation through the ASX but through an investment bank.*

67. A futures market is
- a. an organised market in which people trade contracts for future delivery of securities, commodities or the value of securities sold in the spot market.
  - b. a dealer market for contracts to buy (or sell) a particular type of security or commodity from (or to) the futures exchange during a predetermined future time period.
  - c. an over-the-counter market in which people trade contracts for future delivery of securities, commodities or the value of securities sold in the spot market.
  - d. a dealer market in which securities that are not sold on one of the organised exchanges are traded.

*Correct answer: a*

*Learning Objective 1.4 ~ Describe the various types of financial markets*

68. Which of the following statements is NOT correct?

- a. Deficit spending units raise funds by issuing financial claims in the primary market.
- b. Owners of financial claims can sell them in the secondary market before maturity date.
- c. A financial claim has one issuer but possibly successive owners through the secondary market.
- d. Owners of financial claims can sell them in the primary market.

*Correct answer: d*

*Learning Objective 1.4 ~ Describe the various types of financial markets*

69. An organised security exchange

- a. is accessible by authorised traders only.
- b. has no central location.
- c. is a primary market.
- d. relies on dealers for trading.

*Correct answer: a*

*Learning Objective 1.4 ~ Describe the various types of financial markets*

70. Foreign currencies are traded against the Australian dollar

- a. over-the-counter for futures contracts.
- b. over-the-counter for spot delivery.
- c. in an organised exchange for forward delivery.
- d. in an organised exchange for spot and forward delivery.

*Correct answer: b*

*Learning Objective 1.4 ~ Describe the various types of financial markets*

71. Which of the following statements is NOT correct?

- a. Money markets are operated by dealers.
- b. Money market transactions are seldom below \$1 million.
- c. Money market securities are issued to finance long-term project.
- d. Money market securities have short-term maturity.

*Correct answer: c*

*Learning Objective 1.5 ~ Explain the economic function of the money markets and identify the most important money-market securities*

*Feedback: Money markets are markets for managing liquidity. Governments and companies borrow short term to finance current operations, not long term investments, or lent to avoid holding idle cash in the short term. Money markets tend to be wholesale (i.e. large denominations) OTC markets made by dealers.*

72. Which of the following financial claims does NOT belong to the money market?

- a. Treasury note
- b. Commercial paper
- c. Bank bill
- d. Corporate bond

*Correct answer: d*

*Learning Objective 1.5 ~ Explain the economic function of the money markets and identify the most important money-market securities*

*Feedback: Money markets refer to the markets for financial claims with an original maturity less than one year. Bonds are usually issued with an original maturity of 5 to 30 years and therefore do not belong to the money market.*

73. 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

*Correct answer: b*

*Learning Objective 1.5 ~ Explain the economic function of the money markets and identify the most important money-market securities*

74. Which of the following statements (concerning the money markets) is NOT correct?
- a. Treasury notes are issued at a discount.
  - b. Commercial bills have an active secondary market.
  - c. Commercial paper is issued by the Federal government.
  - d. Commercial paper does not have an active secondary market.

*Correct answer: c*

*Learning Objective 1.5 ~ Explain the economic function of the money markets and identify the most important money-market securities*

75. Which of the following statements (concerning the money markets) is NOT correct?
- a. Commercial paper is a security accepted by commercial banks.
  - b. Treasury notes are issued by the government.
  - c. Commercial bills are the largest component of the money market.
  - d. Negotiable certificates of deposits have a secondary market.

*Correct answer: a*

*Learning Objective 1.5 ~ Explain the economic function of the money markets and identify the most important money-market securities*

76. The main issuers for short-term debt outstanding in Australia are
- a. government and its agencies.
  - b. banks and other financial corporations.
  - c. non-financial corporations.
  - d. non-residents.

*Correct answer: b*

*Learning Objective 1.5 ~ Explain the economic function of the money markets and identify the most important money-market securities*

77. Which of the following financial claims does NOT belong to the capital market?

- a. Government bond
- b. Share
- c. Bank bill
- d. Corporate bond

*Correct answer: c*

*Learning Objective 1.6 ~ Explain the economic function of the capital markets and identify the most important capital-market securities*

*Feedback: Capital market refers to the market for financial claims with an original maturity larger than one year. Bonds issued by governments or corporations belong to that category as they are usually issued with an original maturity of 5 to 30 years. Shares have an unlimited maturity as they exist as long as the company operates. Shares therefore belong to capital market. Bank bills are issued by banks on behalf of a corporation and sold by banks to investors with an original maturity less than one year. They therefore belong to the money market.*

78. Which of the following characteristics does NOT apply to a share?

- a. The investor is entitled to a part of the company's profit.
- b. The issuer will never pay back the funds received.
- c. Investors benefit from an active secondary market.
- d. In the event of bankruptcy investors have a claim on the company's assets before creditors.

*Correct answer: d*

*Learning Objective 1.6 ~ Explain the economic function of the capital markets and identify the most important capital-market securities*

*Feedback: In case of bankruptcy the shareholders are the last ones to be paid out of the proceeds of liquidated assets. This is a consequence of being the owners of the company. Debt holders (creditors) have indeed priority over these assets. The shareholder is not repaid for the amount he/she invested but becomes owner of the company (equity not debt). That ownership explains why he/she is entitled to a share of the profits generated by the company. As shares have no maturity date, the existence of a secondary market is essential. With shares being potentially forever in the financial system the number of changes in their ownership is bound to be important.*



79. Corporate bonds

- a. are issued by governments.
- b. have a maturity lower than one year.
- c. have a very active secondary market.
- d. provide funding for capital expenditure.

*Correct answer: d*

*Learning Objective 1.6 ~ Explain the economic function of the capital markets and identify the most important capital-market securities*

80. Shares

- a. are issued by governments.
- b. have a maturity lower than one year.
- c. have a very active secondary market.
- d. pay interests to their owners.

*Correct answer: c*

*Learning Objective 1.6 ~ Explain the economic function of the capital markets and identify the most important capital-market securities*

81. Mortgage loans 按揭贷款

- a. are secured by real estate.
- b. have a very active secondary market.
- c. provide funds to financing family housing exclusively.
- d. entitle the provider of funds to a share of the company's profits.

*Correct answer: a*

*Learning Objective 1.6 ~ Explain the economic function of the capital markets and identify the most important capital-market securities*

82. Which of the following statement does NOT apply to Islamic banking?

- a. Payments of interests are prohibited.
- b. Lending can only be done to businesses located in countries obeying the Sharia Law.
- c. Lending to businesses producing or dealing with alcohol is prohibited.
- d. Speculation has to be avoided. 不可以投机

*Correct answer: b*

*Learning Objective 1.6 ~ Explain the economic function of the capital markets and identify the most important capital-market securities*

83. The risk that a company will not generate sufficient cash inflow to meet required cash outflows is called
- a. liquidity risk.
  - b. credit risk.
  - c. operational risk.
  - d. political risk.

*Correct answer: a*

*Learning Objective 1.7 ~ Identify the key risks that financial institutions face and describe how they manage these risks*

*Feedback: Credit risk is the risk that the borrower does not repay the principal or the interests. Operational risk refers to any dysfunctioning in the organisation of the company. Political risk occurs when government changes regulation/policies or changes the terms of a financial contract by which it borrowed funds.*

84. The risk that a borrower does not repay the principal or the interests is called
- a. operational risk.
  - b. liquidity risk.
  - c. political risk.
  - d. credit risk.

*Correct answer: d*

*Learning Objective 1.7 ~ Identify the key risks that financial institutions face and describe how they manage these risks*

85. The risk that a government decides to change the terms of a financial contract by which it borrowed funds is an example of
- a. operational risk.
  - b. liquidity risk.
  - c. political risk.
  - d. credit risk.

*Correct answer: c*

*Learning Objective 1.7 ~ Identify the key risks that financial institutions face and describe how they manage these risks.*

## **Essay Questions – Prepared by Christopher Gan**

86. Discuss the importance of financial intermediation in the financial system.

Answer: Financial intermediation is a situation where some institutions called financial intermediaries are helping with the channelling of funds in the financial system: they issue financial claims to surplus spending units and use the funds they collected to buy financial claims issued by deficit spending units. Direct finance refers to the alternative situation where the financial claims issued by deficit spending units are held/owned directly by the surplus spending units, not by financial institutions. Direct finance however is hard to achieve as many financial claims only sell in large denomination packages in the primary and secondary markets, and therefore are beyond the individual financial capacity of the surplus spending units. If we disregard informal lending among friends and family that is not part of the official financial system, direct finance in Australia mainly takes the form of households holding non-financial shares as there is no access restriction to the ASX for retail investors. In addition direct finance can marginally take the form of households holding government bonds, as the RBA manages a small investor bond facility. The direct access to corporate debt securities is currently impossible for retail investors for the reason mentioned earlier. For these reasons, financial intermediaries dominate the financial system in Australia and are the ones that most surplus spending units (SSUs) and deficit spending units (DSUs) transact with when they seek financial services. Financial intermediaries transform claims to make them more attractive to DSUs and SSUs. The transformation provided by financial intermediaries include: denomination divisibility; currency transformation; maturity flexibility; credit risk diversification; and liquidity. Financial intermediaries benefit from three sources of comparative advantages over surplus spending units investing directly: economies of scale that reduces the cost per transaction, lower transaction costs for credit information and better access to sensitive information about borrowers. Without financial intermediation, the channelling of funds between SSUs and DSUs would be very costly and inefficient.

87. What are the roles of secondary capital market in the financial system?

Answer: The main function of secondary markets is to provide liquidity for investors who own financial claims. While securities can only be sold once in a primary market where they are issued by the recipients of funds, all subsequent transactions take place in secondary markets among investors. The Australian Stock Exchange (ASX), where shares are traded, is an example of a well-known secondary market. The existence of secondary markets has a favourable impact on the primary markets. Deficit spending units would not easily find investors ready to commit their funds for long periods as the latter may have unexpected expenditure in the future. Many long term investments by corporations could not be implemented by lack of funding. As a consequence the primary market for long term maturity securities would not be operational without the existence of secondary markets. Secondary markets allow that the same long term security is owned by successive investors for possibly short periods.

Secondary markets are essential for investors to readjust their portfolios in order to keep them at a desired level of risk-expected return.

The second main role of secondary markets is to provide a valuation for the financial asset at any time, which is important even for investors that do not trade the assets. This process is referred to as price discovery.

88. Explain why the money market is so important in the economy.

Answer: The money market is important because it provides funding and investment opportunity to corporations and governments for short periods. For most businesses the income does not coincide in time with the expenses; some expenses need to be paid before receiving the income of the sale. Being able to borrow when the expenses come first (or lending when the income comes first) is therefore essential for the daily management of a company. For corporations like insurance companies that do not know their future liquidity needs, it is necessary to have short term assets in the portfolio that mature soon or have a very active secondary market.

The money market is also the market in which central banks conduct monetary policy through short term repurchase agreements (typically two weeks maturity) with the objective to influence a very short term interest rate, the overnight interbank market interest rate, called the cash rate in Australia.

89. Explain the differences between brokers and dealers in the financial market.

Answer: Brokers and dealers' common role is to assist in the trading in secondary markets. Although operating within financial companies, dealers and brokers are not financial intermediaries but simply go-between in the transactions of selling and buying securities. Brokers do not actually buy or sell securities for their own account; they only execute their clients' transactions at the best possible price and earn a commission. In organised markets, where trading is limited to authorised members, using brokers is unavoidable. Trade at the end takes place between the buyer and the seller of the security even though each has used a broker to bring their orders to the market. Dealers, on the other hand, 'make markets' for securities, i.e. trade for their own account. They are the key actors in over-the-counter markets. Dealers carry an inventory of securities from which they stand ready either to buy or sell particular securities at quoted prices. The buyers and sellers do not trade among themselves but each trades with the dealer. The dealer's bid price is the price it requires when purchasing a security from a seller and the ask price is the price it charges the buyers. They make profits by selling from their inventory, on average, for a higher price than they paid for them. Because a security may sit in the inventory for a while before finding a buyer the profit made by the dealer for trading that security is not necessarily the difference between the ask price and the bid price of a given pair of quoted prices. Contrary to a broker the transaction may generate a negative profit if the security sits long enough in the inventory so that the ask price has to decrease below the bid price at the time of the purchase of the security. Brokers may also be used by sellers and buyers to find the best dealer.