

## Chapter 02

### Financial Markets and Institutions

#### True / False Questions

1. Only small companies can go through financial markets to obtain financing.

True   False

2. The reinvestment of cash back into the firm's operations is an example of a flow of savings to investment.

True   False

3. Smaller businesses are especially dependent upon internally generated funds.

True   False

4. An individual can save and invest in a corporation only by lending money to it or by purchasing additional shares.

True   False

5. Previously issued securities are traded among investors in the secondary markets.

True   False

6. Only the IPOs for large corporations are sold in primary markets.

True False

7. Hedge fund managers, unlike mutual fund managers, do not receive fund-performance-related fees.

True False

8. The markets for long-term debt and equity are called capital markets.

True False

9. The stocks of major corporations trade in many markets throughout the world on a continuous or near-continuous basis.

True False

10. The derivative market is also a source of financing for corporations.

True False

11. During the Financial Crisis of 2007-2009, the U.S. government bailed out all firms in danger of failing.

True False

12. In the United States, banks are the most important source of long-term financing for businesses.

True False

13. A financial intermediary invests in financial assets rather than real assets.

True False

14. Households hold more than half of U.S. corporate equities.

True False

15. The key to the banks' ability to make illiquid loans is their ability to pool liquid deposits from thousands of depositors.

True False

16. From June 2001 to June 2006, housing prices in the United States doubled.

True False

17. For corporate bonds, the higher the credit quality of an issuer, the higher the interest rate.

True False

18. The cost of capital is the interest rate paid on a loan from a bank or some other financial institution.

True False

19. Like public companies, private companies can also use their stock price as a measure of performance.

True False

20. The opportunity cost of capital is the expected rate of return that shareholders can obtain in the financial markets on investments with the same risk as the firm's capital investments.

True   False

21. Apple Computer is well known for its product innovations. Access to financing was vital to Apple's growth and profitability.

True   False

22. Whenever there is uncertainty, investors might be interested in trading, either to speculate or to lay off their risks, and a market may rise to meet the trading demand.

True   False

23. Financial markets and intermediaries allow investors and businesses to reduce and reallocate risk.

True   False

24. The effects of the financial crisis of 2007-2009 were confined to the U.S. and domestic companies.

True   False

25. The cost of capital is the minimum acceptable rate of return for capital investment.

True   False

26. One root of the financial crisis of 2007-2009 was the strict money policies promoted by the U.S. Federal Reserve and other central banks after the technology bubble burst (i.e., money was relatively expensive during this time).

True   False

27. The rates of return on investments outside the corporation set the minimum return for investment projects inside the corporation.

True False

28. Financing for public corporations must flow through financial markets.

True False

29. Financing for private corporations must flow through financial intermediaries.

True False

30. Almost all foreign exchange trading occurs on the floors of the FOREX exchanges in New York and London.

True False

### Multiple Choice Questions

31. Corporate financing comes ultimately from:

- A. savings by households and foreign investors.
- B. cash generated from the firm's operations.
- C. the financial markets and intermediaries.
- D. the issue of shares in the firm.

32. A company can pay for its expansion in all the following ways *except*.
- A. by using the earnings generated from its sale of obsolete equipment.
  - B. by persuading a director's mother to make a personal loan to the company.
  - C. by purchasing bonds in the secondary market.
  - D. by selling stock certificates for a new subsidiary.
33. "Reinvestment" means:
- A. new investment in new operations.
  - B. additional investment in existing operations.
  - C. new investment by new shareholders.
  - D. additional investment by existing shareholders.
34. Financing for public corporations flows through:
- A. the financial markets only.
  - B. financial intermediaries only.
  - C. derivatives markets.
  - D. the financial markets, financial intermediaries, or both.
35. When corporations need to raise funds through stock issues, they rely on the:
- A. primary market.
  - B. secondary market.
  - C. tertiary market.
  - D. centralized NASDAQ exchange.

36. A primary market would be utilized when:

- A. investors buy or sell existing securities.
- B. shares of common stock are exchanged.
- C. securities are initially issued.
- D. a commission must be paid on the transaction.

37. The primary distinction between securities sold in the primary and secondary markets is the:

- A. riskiness of the securities.
- B. price of the securities.
- C. previous issuance of the securities.
- D. profitability of the issuing corporation.

38. Which of the following are both a financial intermediary and a financial institution?

- A. Mutual funds
- B. Pension funds
- C. Insurance companies
- D. Hedge funds

39. A share of IBM stock is purchased by an individual investor for \$75 and later sold to another investor for \$125. Who profits from this sale?

- A. IBM
- B. The first investor
- C. The second investor
- D. IBM and both investors

40. Which of the following financial assets is *least* likely to have an active secondary market?
- A. Common stock of a large public firm
  - B. Bank loans made to smaller firms
  - C. Bonds of a major, multinational corporation
  - D. Debt issued by the U.S. Treasury
41. When Patricia sells her General Motors common stock at the same time that Brian purchases the same amount of GM stock, GM receives:
- A. the dollar value of the transaction.
  - B. the dollar amount of the transaction, less brokerage fees.
  - C. only the par value of the common stock.
  - D. nothing.
42. Which one of these is a money market security?
- A. Commercial paper
  - B. Common stock
  - C. 2-year bond
  - D. 20-year bond



43. A mother in a developing country wants to borrow the equivalent of \$20 to enable her to start a small restaurant run by her family. Which type of financing is she looking to obtain?
- A. Public bond issue
  - B. IPO
  - C. Micro loan
  - D. Futures contract on a commodity
44. Corporate debt instruments are most commonly traded:
- A. on the NYSE.
  - B. on NASDAQ.
  - C. in the money market.
  - D. in the over-the-counter market.
45. A bond differs from a share of stock in that a bond:
- A. represents a claim on the firm.
  - B. has more risk.
  - C. has guaranteed returns.
  - D. has a maturity date.
46. Short-term financing decisions commonly occur in the:
- A. primary markets.
  - B. secondary markets.
  - C. capital markets.
  - D. money markets.

47. Long-term financing decisions commonly occur in the:

- A. option markets.
- B. secondary markets.
- C. capital markets.
- D. money markets.

48. You can buy silver in the:

- A. capital markets.
- B. foreign exchange markets.
- C. commodities markets.
- D. option markets.

49. Commodity and derivative markets:

- A. are additional sources of financing for corporate projects.
- B. enable the financial manager to adjust a firm's exposure to various business risks.
- C. are always over-the-counter markets.
- D. deal only in foreign currencies.

50. Foreign currencies are traded:

- A. only by banks in New York and London.
- B. over the counter.
- C. on both the NYSE and NASDAQ.
- D. on the Intercontinental Exchange.

51. Which one of the following statements is *not* characteristic of mutual funds?

- A. They are always considered to be financial institutions.
- B. They raise money by selling shares to investors.
- C. They pool the savings of many investors.
- D. They offer professional management and portfolio diversification.

52. Which one of these correctly applies to mutual funds?

- A. Mutual funds are a costly means of achieving portfolio diversification.
- B. Funds are required to limit their annual fees and expenses to less than 1 percent of the portfolio value.
- C. You can generally buy additional shares in the fund at any time.
- D. Shareholders sell their shares to other shareholders.

53. "Balanced" mutual funds:

- A. invest in both stocks and bonds.
- B. spread their investments equally over a specified geographic area.
- C. spread their investments equally over various industries.
- D. charge a management fee that is proportionate to the investment return.

54. Who was responsible for the financial crisis of 2007-2009?

- A. The U.S. Federal Reserve, for its policy of easy money
- B. The U.S. government, for pushing banks to expand credit for low-income housing
- C. Bankers, who aggressively promoted and resold subprime mortgages
- D. The U.S. Federal Reserve, the U.S. government, rating agencies, and bankers

55. Which one of the following funds provides a tax advantage to individual investors?

- A. Balanced funds
- B. Pension funds
- C. Bond funds
- D. Funds that invest in foreign countries

56. A financial institution:

- A. is a kind of financial intermediary.
- B. simply pools and invests savings.
- C. raises financing by selling shares.
- D. invests primarily in commodities.

57. Which type of financial institution generally does not accept deposits but does underwrite stock offerings?

- A. Insurance company
- B. Mutual fund
- C. Commercial bank
- D. Investment bank

58. Which one of the following financial intermediaries has shown the greatest preference for investing in *long-term* financial assets?
- A. Commercial banks
  - B. Insurance companies
  - C. Finance companies
  - D. Savings banks
59. Which one of these may provide a financial return to some investors while not providing any financial return to other investors?
- A. Mutual funds
  - B. Pension funds
  - C. Insurance companies
  - D. Hedge fund
60. Insurance companies can usually cover the claims of policyholders because:
- A. the incidence of claims normally averages out across all policyholders.
  - B. they issue a very limited number of policies.
  - C. they are fully insured by the U.S. government.
  - D. their stockholders will cover any cash shortfalls encountered by the company.

61. Which of the following is *not* typically considered a function of financial intermediaries?

- A. Providing a payment mechanism
- B. Investing in real assets
- C. Accumulating funds from smaller investors
- D. Spreading, or pooling risk among individuals

62. U.S. bonds and other debt securities are mostly held by:

- A. institutional investors.
- B. households.
- C. foreign investors.
- D. state and local governments.

63. Approximately what percentage of U.S. corporate equities are held by households?

- A. 25%
- B. 40%
- C. 50%
- D. 60%

64. In 2012, U.S. corporate and foreign bonds totaled:

- A. less than \$500 billion.
- B. about \$3 trillion.
- C. about \$7 trillion.
- D. more than \$12 trillion.

65. In 2012, U.S. corporate equities totaled:

- A. less than \$6 trillion.
- B. about \$10 trillion.
- C. about \$16 trillion.
- D. more than \$25 trillion.

66. Which one of these transports income forward in time?

- A. Retirement savings
- B. Car loan
- C. Bank line of credit
- D. Credit card purchase

67. Which one of these assists in shifting an individual's consumption forward in time?

- A. A bank line of credit
- B. A bank savings account
- C. A life insurance policy
- D. A retirement savings plan

68. One reason suggesting that banks may be better than individuals at matching lenders to borrowers is that banks:

- A. can shift loan risk to their deposit customers.
- B. are motivated by the potential for profit.
- C. do not have any income tax liability.
- D. have information to evaluate creditworthiness.

69. Which one of the following is *least* liquid?

- A. Foreign currency
- B. U.S. Treasury bonds
- C. Real estate
- D. Savings deposit

70. Financial markets and intermediaries:

- A. channel savings to real investment.
- B. increase risks for businesses.
- C. generally reduce the liquidity of securities.
- D. prevent the transportation of cash across time.

71. Which of the following functions does *not* require financial markets?

- A. Transporting of cash across time
- B. Provision of liquidity
- C. Risk reduction by investment in diversified portfolios
- D. Provision of pricing information

72. Liquidity is important to a mutual fund primarily because:

- A. a fund that is less liquid will attract more investors.
- B. the fund's shareholders may want to redeem their shares at any time.
- C. new investors may invest in the fund at any time.
- D. the fund requires cash to pay its taxes.



73. Which one of the following is the biggest provider of payment mechanisms?

- A. Hedge funds
- B. Banks
- C. Mutual funds
- D. Insurance companies

74. Which of the following actions does *not* help reduce risk?

- A. Extending the service warranty for your notebook
- B. Converting your money market account to a mutual fund account
- C. Contracting to sell your farm produce to the neighborhood grocery
- D. Buying Japanese yen now when you plan to study in Japan next year

75. Insurance companies primarily reduce an individual's risk by:

- A. transporting that risk forward in time.
- B. providing payment services.
- C. spreading that risk across many individuals.
- D. providing low-interest-rate loans.

76. Which of the following information is *not* provided by the financial markets?

- A. The price of six ounces of gold
- B. The cost of borrowing \$500,000 for 5 years
- C. Microsoft's earnings in 2013
- D. The cost of one million yen in U.S. dollars

77. A capital investment that generates a 10% rate of return is worthwhile if:

- A. corporate bonds of similar risk offer 8% rates of return.
- B. corporate bonds of similar risk offer 11% rates of return.
- C. top-quality corporate bonds offer 10% rates of return.
- D. the expected rate of return on the stock market is 12%.

78. The cost of capital:

- A. is the expected rate of return on a capital investment.
- B. is an opportunity cost determined by the risk-free rate of return.
- C. is the interest rate that the firm pays on a loan from a bank or insurance company.
- D. for risky investments is normally higher than the firm's borrowing rate.

79. Excess cash held by a firm should be:

- A. reinvested by the firm in projects offering the highest rate of return.
- B. reinvested by the firm in projects offering rates of return higher than the cost of capital.
- C. reinvested by the firm in the financial markets.
- D. distributed to bondholders in the form of extra coupon payments.

80. One contributing factor to the 2007-2009 financial crisis was the structuring of mortgage loans with:

- A. high initial payments, offset by significantly lower payments later.
- B. low initial payments, offset by significantly higher payments later.
- C. no initial payments, offset by significantly high payments later.
- D. equal payments over the life of the loan.

81. The opportunity cost of capital:

- A. is the interest rate that the firm pays on a loan from a financial institution.
- B. is the maximum acceptable rate of return on a project.
- C. is the minimum acceptable rate of return on a project.
- D. is always less than 10%.

82. During the Financial Crisis of 2007-2009, the U.S. government bailed out all of the following firms *except*:

- A. AIG.
- B. Fannie Mae.
- C. Lehman Brothers.
- D. Freddie Mac.

83. If Apple Computer Inc. is used as the model, then new firms should expect to raise capital in which one of these orders? Start with the first money raised.

- A. Owners, venture capitalists, suppliers, public investors
- B. Owners, suppliers, venture capitalists, public investors
- C. Venture capitalists, owners, public investors, suppliers
- D. Owners, public investors, venture capitalists, suppliers

84. Which one of these parties *cannot* invest in a hedge fund?

- A. Small retail investors
- B. Pension funds
- C. Insurance companies
- D. Wealthy individuals

85. Which one of these enterprises generally acts as an underwriter for an initial public offering?

- A. Commercial bank
- B. Government
- C. Investment bank
- D. Insurance company

86. Approximately what percent of the shares issued by U.S. corporations are held by investors outside of the U.S.?

- A. 5%
- B. 12%
- C. 16%
- D. 24%

87. Firms can often determine the current price of any commodities they use in their production process by consulting the price quotes provided by:

- A. their investment bank.
- B. the New York Mercantile Exchange.
- C. the New York Stock Exchange.
- D. the Standard & Poor's market indexes.

88. How is the relationship between a bond's credit rating and its interest rate best defined?

- A. Inverse relationship
- B. Direct relationship
- C. Unrelated
- D. Logarithmic

89. The financial crisis of 2007-2009 contributed to the largest sovereign default in history by which one of these countries?

- A. Italy
- B. Portugal
- C. Ireland
- D. Greece

90. Which one of these was a contributing factor to the need for many foreign banks to seek aid from their governments as a result of the financial crisis of 2007-2009?

- A. Decrease in their exchange rates
- B. Investments in U.S. subprime mortgages
- C. Interest rate spikes
- D. Currency controls

91. Which one of these was a major cause of the deep recession and severe unemployment throughout much of Europe that followed the financial crisis of 2007-2009?

- A. Government actions to raise interest rates
- B. Investor speculation
- C. Risk-adverse investor attitudes
- D. Government actions to lower government debt

92. Which one of these is generally a key difference between U.S. and foreign commercial banks?

- A. Pooling and investing savings
- B. Accepting investor deposits
- C. Providing debt financing to corporations
- D. Making equity investments in corporations

## Essay Questions

93. How can an individual save and invest in a corporation?

94. Why are secondary market transactions of importance to corporations?

95. What is meant by over-the-counter trading?

96. Describe the distinguishing characteristics of the major financial markets.
97. What are the advantages of investing indirectly in stocks and bonds via mutual funds and pension funds?
98. What are the key differences between a financial intermediary and a financial institution?



99. What are the largest institutional investors in bonds? In stocks?

100. What are the functions of financial markets?

101. How can the financial manager identify the cost of the capital raised by a corporation?

102. Why do nonfinancial corporations need modern financial markets and institutions?

103. How was the role of many bankers in the Financial Crisis of 2007-2009 an example of an agency problem?

104. Investing \$100,000 in additional raw materials today—mostly in palladium—should allow Cryogenic Concepts to increase production and earn an additional \$112,000 next year. This payoff would cover the investment today, plus a 12% return. Palladium is traded in commodity markets. The CFO has studied the history of returns on investments in palladium and believes that investors in that precious metal can reasonably expect a 15% return. Is Cryogenic's investment in palladium a good idea? Why or why not?

105. Rhonda and Reggie Hotspur are working hard to save for their children's college educations. They don't need more cash for current consumption but will face big tuition bills in 2020. Should they therefore avoid investing in stocks that pay generous current cash dividends? Explain briefly.

106. What is an exchange traded fund? What are some popular choices of exchange traded funds?

107. What are subprime mortgages and how were they a part of the Financial Crisis of 2007-2009?

## Chapter 02 Financial Markets and Institutions **Answer Key**

### True / False Questions

1. Only small companies can go through financial markets to obtain financing.

**FALSE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

2. The reinvestment of cash back into the firm's operations is an example of a flow of savings to investment.

**TRUE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Financial institution functions*

3. Smaller businesses are especially dependent upon internally generated funds.

**TRUE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Financial institution functions*

4. An individual can save and invest in a corporation only by lending money to it or by purchasing additional shares.

**FALSE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Financial institution functions*

5. Previously issued securities are traded among investors in the secondary markets.

**TRUE**

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Primary and secondary markets*

6. Only the IPOs for large corporations are sold in primary markets.

**FALSE**

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Initial public offerings*

7. Hedge fund managers, unlike mutual fund managers, do not receive fund-performance-related fees.

**FALSE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

8. The markets for long-term debt and equity are called capital markets.

**TRUE**

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Capital markets*

9. The stocks of major corporations trade in many markets throughout the world on a continuous or near-continuous basis.

**TRUE**

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Stock trading*

10. The derivative market is also a source of financing for corporations.

**FALSE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Derivatives and other securities*

11. During the Financial Crisis of 2007-2009, the U.S. government bailed out all firms in danger of failing.

**FALSE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

12. In the United States, banks are the most important source of long-term financing for businesses.

**FALSE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Financial institution functions*



13. A financial intermediary invests in financial assets rather than real assets.

TRUE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Financial institutions*

14. Households hold more than half of U.S. corporate equities.

FALSE

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Raising capital*

15. The key to the banks' ability to make illiquid loans is their ability to pool liquid deposits from thousands of depositors.

TRUE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

16. From June 2001 to June 2006, housing prices in the United States doubled.

TRUE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

17. For corporate bonds, the higher the credit quality of an issuer, the higher the interest rate.

FALSE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Bond ratings and credit risk*

18. The cost of capital is the interest rate paid on a loan from a bank or some other financial institution.

FALSE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Cost of capital-general*

19. Like public companies, private companies can also use their stock price as a measure of performance.

**FALSE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Stock market prices and reporting*

20. The opportunity cost of capital is the expected rate of return that shareholders can obtain in the financial markets on investments with the same risk as the firm's capital investments.

**TRUE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Expected (required) return*

21. Apple Computer is well known for its product innovations. Access to financing was vital to Apple's growth and profitability.

**TRUE**

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Raising capital*

22. Whenever there is uncertainty, investors might be interested in trading, either to speculate or to lay off their risks, and a market may rise to meet the trading demand.

TRUE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

23. Financial markets and intermediaries allow investors and businesses to reduce and reallocate risk.

TRUE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

24. The effects of the financial crisis of 2007-2009 were confined to the U.S. and domestic companies.

FALSE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

25. The cost of capital is the minimum acceptable rate of return for capital investment.

TRUE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Expected (required) return*

26. One root of the financial crisis of 2007-2009 was the strict money policies promoted by the U.S. Federal Reserve and other central banks after the technology bubble burst (i.e., money was relatively expensive during this time).

FALSE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

27. The rates of return on investments outside the corporation set the minimum return for investment projects inside the corporation.

TRUE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Expected (required) return*

28. Financing for public corporations must flow through financial markets.

FALSE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

29. Financing for private corporations must flow through financial intermediaries.

FALSE

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

30. Almost all foreign exchange trading occurs on the floors of the FOREX exchanges in New York and London.

FALSE

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Foreign exchange markets*

## Multiple Choice Questions

31. Corporate financing comes ultimately from:

- A. savings by households and foreign investors.
- B. cash generated from the firm's operations.
- C. the financial markets and intermediaries.
- D. the issue of shares in the firm.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Financial institution functions*

32. A company can pay for its expansion in all the following ways *except*:

- A. by using the earnings generated from its sale of obsolete equipment.
- B. by persuading a director's mother to make a personal loan to the company.
- C. by purchasing bonds in the secondary market.
- D. by selling stock certificates for a new subsidiary.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Raising capital*

33. "Reinvestment" means:

- A. new investment in new operations.
- B. additional investment in existing operations.
- C. new investment by new shareholders.
- D. additional investment by existing shareholders.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Raising capital*

34. Financing for public corporations flows through:

- A. the financial markets only.
- B. financial intermediaries only.
- C. derivatives markets.
- D. the financial markets, financial intermediaries, or both.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*



35. When corporations need to raise funds through stock issues, they rely on the:

- A. primary market.
- B. secondary market.
- C. tertiary market.
- D. centralized NASDAQ exchange.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Primary and secondary markets*

36. A primary market would be utilized when:

- A. investors buy or sell existing securities.
- B. shares of common stock are exchanged.
- C. securities are initially issued.
- D. a commission must be paid on the transaction.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Primary and secondary markets*

37. The primary distinction between securities sold in the primary and secondary markets is the:

- A. riskiness of the securities.
- B. price of the securities.
- C. previous issuance of the securities.
- D. profitability of the issuing corporation.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Primary and secondary markets*

38. Which of the following are both a financial intermediary and a financial institution?

- A. Mutual funds
- B. Pension funds
- C. Insurance companies
- D. Hedge funds

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institutions*

39. A share of IBM stock is purchased by an individual investor for \$75 and later sold to another investor for \$125. Who profits from this sale?

- A. IBM
- B. The first investor**
- C. The second investor
- D. IBM and both investors

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Stock returns and yields*

40. Which of the following financial assets is *least* likely to have an active secondary market?

- A. Common stock of a large public firm
- B. Bank loans made to smaller firms**
- C. Bonds of a major, multinational corporation
- D. Debt issued by the U.S. Treasury

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 3 Hard*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Primary and secondary markets*

41. When Patricia sells her General Motors common stock at the same time that Brian purchases the same amount of GM stock, GM receives:

- A. the dollar value of the transaction.
- B. the dollar amount of the transaction, less brokerage fees.
- C. only the par value of the common stock.
- D. nothing.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Primary and secondary markets*

42. Which one of these is a money market security?

- A. Commercial paper
- B. Common stock
- C. 2-year bond
- D. 20-year bond

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Money and capital markets*

43. A mother in a developing country wants to borrow the equivalent of \$20 to enable her to start a small restaurant run by her family. Which type of financing is she looking to obtain?

- A. Public bond issue
- B. IPO
- C. Micro loan
- D. Futures contract on a commodity

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Debt*

44. Corporate debt instruments are most commonly traded:

- A. on the NYSE.
- B. on NASDAQ.
- C. in the money market.
- D. in the over-the-counter market.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Primary and secondary markets*

45. A bond differs from a share of stock in that a bond:

- A. represents a claim on the firm.
- B. has more risk.
- C. has guaranteed returns.
- D. has a maturity date.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Bond features*

46. Short-term financing decisions commonly occur in the:

- A. primary markets.
- B. secondary markets.
- C. capital markets.
- D. money markets.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Money and capital markets*

47. Long-term financing decisions commonly occur in the:

- A. option markets.
- B. secondary markets.
- C. capital markets.
- D. money markets.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Money and capital markets*

48. You can buy silver in the:

- A. capital markets.
- B. foreign exchange markets.
- C. commodities markets.
- D. option markets.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Money and capital markets*

49. Commodity and derivative markets:

- A. are additional sources of financing for corporate projects.
- B.** enable the financial manager to adjust a firm's exposure to various business risks.
- C. are always over-the-counter markets.
- D. deal only in foreign currencies.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 3 Hard*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Derivatives and other securities*

50. Foreign currencies are traded:

- A. only by banks in New York and London.
- B.** over the counter.
- C. on both the NYSE and NASDAQ.
- D. on the Intercontinental Exchange.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Foreign exchange markets*



51. Which one of the following statements is *not* characteristic of mutual funds?

- A. They are always considered to be financial institutions.
- B. They raise money by selling shares to investors.
- C. They pool the savings of many investors.
- D. They offer professional management and portfolio diversification.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

52. Which one of these correctly applies to mutual funds?

- A. Mutual funds are a costly means of achieving portfolio diversification.
- B. Funds are required to limit their annual fees and expenses to less than 1 percent of the portfolio value.
- C. You can generally buy additional shares in the fund at any time.
- D. Shareholders sell their shares to other shareholders.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

53. "Balanced" mutual funds:

- A. invest in both stocks and bonds.
- B. spread their investments equally over a specified geographic area.
- C. spread their investments equally over various industries.
- D. charge a management fee that is proportionate to the investment return.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

54. Who was responsible for the financial crisis of 2007-2009?

- A. The U.S. Federal Reserve, for its policy of easy money
- B. The U.S. government, for pushing banks to expand credit for low-income housing
- C. Bankers, who aggressively promoted and resold subprime mortgages
- D. The U.S. Federal Reserve, the U.S. government, rating agencies, and bankers

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

55. Which one of the following funds provides a tax advantage to individual investors?

- A. Balanced funds
- B. Pension funds**
- C. Bond funds
- D. Funds that invest in foreign countries

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

56. A financial institution:

- A. is a kind of financial intermediary.**
- B. simply pools and invests savings.
- C. raises financing by selling shares.
- D. invests primarily in commodities.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 3 Hard*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institutions*

57. Which type of financial institution generally does not accept deposits but does underwrite stock offerings?

- A. Insurance company
- B. Mutual fund
- C. Commercial bank
- D. Investment bank

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

58. Which one of the following financial intermediaries has shown the greatest preference for investing in *long-term* financial assets?

- A. Commercial banks
- B. Insurance companies
- C. Finance companies
- D. Savings banks

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Financial institution functions*

59. Which one of these may provide a financial return to some investors while not providing any financial return to other investors?

- A. Mutual funds
- B. Pension funds
- C. Insurance companies
- D. Hedge fund

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

60. Insurance companies can usually cover the claims of policyholders because:

- A. the incidence of claims normally averages out across all policyholders.
- B. they issue a very limited number of policies.
- C. they are fully insured by the U.S. government.
- D. their stockholders will cover any cash shortfalls encountered by the company.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

61. Which of the following is *not* typically considered a function of financial intermediaries?

- A. Providing a payment mechanism
- B. Investing in real assets**
- C. Accumulating funds from smaller investors
- D. Spreading, or pooling risk among individuals

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Financial institution functions*

62. U.S. bonds and other debt securities are mostly held by:

- A. institutional investors.**
- B. households.
- C. foreign investors.
- D. state and local governments.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Raising capital*

63. Approximately what percentage of U.S. corporate equities are held by households?

- A. 25%
- B.** 40%
- C. 50%
- D. 60%

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Raising capital*

64. In 2012, U.S. corporate and foreign bonds totaled:

- A. less than \$500 billion.
- B. about \$3 trillion.
- C. about \$7 trillion.
- D.** more than \$12 trillion.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Raising capital*

65. In 2012, U.S. corporate equities totaled:

- A. less than \$6 trillion.
- B. about \$10 trillion.
- C. about \$16 trillion.
- D. more than \$25 trillion.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Raising capital*

66. Which one of these transports income forward in time?

- A. Retirement savings
- B. Car loan
- C. Bank line of credit
- D. Credit card purchase

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*



67. Which one of these assists in shifting an individual's consumption forward in time?

- A. A bank line of credit
- B. A bank savings account
- C. A life insurance policy
- D. A retirement savings plan

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

68. One reason suggesting that banks may be better than individuals at matching lenders to borrowers is that banks:

- A. can shift loan risk to their deposit customers.
- B. are motivated by the potential for profit.
- C. do not have any income tax liability.
- D. have information to evaluate creditworthiness.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

69. Which one of the following is *least* liquid?

- A. Foreign currency
- B. U.S. Treasury bonds
- C. Real estate
- D. Savings deposit

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

70. Financial markets and intermediaries:

- A. channel savings to real investment.
- B. increase risks for businesses.
- C. generally reduce the liquidity of securities.
- D. prevent the transportation of cash across time.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

71. Which of the following functions does *not* require financial markets?

- A. Transporting of cash across time
- B. Provision of liquidity
- C. Risk reduction by investment in diversified portfolios
- D. Provision of pricing information

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 3 Hard*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

72. Liquidity is important to a mutual fund primarily because:

- A. a fund that is less liquid will attract more investors.
- B. the fund's shareholders may want to redeem their shares at any time.
- C. new investors may invest in the fund at any time.
- D. the fund requires cash to pay its taxes.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 3 Hard*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Financial institution functions*

73. Which one of the following is the biggest provider of payment mechanisms?

- A. Hedge funds
- B. Banks**
- C. Mutual funds
- D. Insurance companies

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

74. Which of the following actions does *not* help reduce risk?

- A. Extending the service warranty for your notebook
- B. Converting your money market account to a mutual fund account**
- C. Contracting to sell your farm produce to the neighborhood grocery
- D. Buying Japanese yen now when you plan to study in Japan next year

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

75. Insurance companies primarily reduce an individual's risk by:

- A. transporting that risk forward in time.
- B. providing payment services.
- C. spreading that risk across many individuals.
- D. providing low-interest-rate loans.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Financial institution functions*

76. Which of the following information is *not* provided by the financial markets?

- A. The price of six ounces of gold
- B. The cost of borrowing \$500,000 for 5 years
- C. Microsoft's earnings in 2013
- D. The cost of one million yen in U.S. dollars

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

77. A capital investment that generates a 10% rate of return is worthwhile if:

- A. corporate bonds of similar risk offer 8% rates of return.
- B. corporate bonds of similar risk offer 11% rates of return.
- C. top-quality corporate bonds offer 10% rates of return.
- D. the expected rate of return on the stock market is 12%.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Expected (required) return*

78. The cost of capital:

- A. is the expected rate of return on a capital investment.
- B. is an opportunity cost determined by the risk-free rate of return.
- C. is the interest rate that the firm pays on a loan from a bank or insurance company.
- D. for risky investments is normally higher than the firm's borrowing rate.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 3 Hard*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Cost of capital-general*

79. Excess cash held by a firm should be:

- A. reinvested by the firm in projects offering the highest rate of return.
- B.** reinvested by the firm in projects offering rates of return higher than the cost of capital.
- C. reinvested by the firm in the financial markets.
- D. distributed to bondholders in the form of extra coupon payments.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Goal of financial management*

80. One contributing factor to the 2007-2009 financial crisis was the structuring of mortgage loans with:

- A. high initial payments, offset by significantly lower payments later.
- B.** low initial payments, offset by significantly higher payments later.
- C. no initial payments, offset by significantly high payments later.
- D. equal payments over the life of the loan.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

81. The opportunity cost of capital:

- A. is the interest rate that the firm pays on a loan from a financial institution.
- B. is the maximum acceptable rate of return on a project.
- C. is the minimum acceptable rate of return on a project.
- D. is always less than 10%.

*AACSB: Communication*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Expected (required) return*

82. During the Financial Crisis of 2007-2009, the U.S. government bailed out all of the following firms *except*:

- A. AIG.
- B. Fannie Mae.
- C. Lehman Brothers.
- D. Freddie Mac.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*



83. If Apple Computer Inc. is used as the model, then new firms should expect to raise capital in which one of these orders? Start with the first money raised.

- A. Owners, venture capitalists, suppliers, public investors
- B.** Owners, suppliers, venture capitalists, public investors
- C. Venture capitalists, owners, public investors, suppliers
- D. Owners, public investors, venture capitalists, suppliers

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Raising capital*

84. Which one of these parties *cannot* invest in a hedge fund?

- A.** Small retail investors
- B. Pension funds
- C. Insurance companies
- D. Wealthy individuals

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Hedging*

85. Which one of these enterprises generally acts as an underwriter for an initial public offering?

- A. Commercial bank
- B. Government
- C. Investment bank
- D. Insurance company

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Underwriting*

86. Approximately what percent of the shares issued by U.S. corporations are held by investors outside of the U.S.?

- A. 5%
- B. 12%
- C. 16%
- D. 24%

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Raising capital*

87. Firms can often determine the current price of any commodities they use in their production process by consulting the price quotes provided by:

- A. their investment bank.
- B.** the New York Mercantile Exchange.
- C. the New York Stock Exchange.
- D. the Standard & Poor's market indexes.

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

88. How is the relationship between a bond's credit rating and its interest rate best defined?

- A.** Inverse relationship
- B. Direct relationship
- C. Unrelated
- D. Logarithmic

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Bond ratings and credit risk*

89. The financial crisis of 2007-2009 contributed to the largest sovereign default in history by which one of these countries?

- A. Italy
- B. Portugal
- C. Ireland
- D. Greece

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

90. Which one of these was a contributing factor to the need for many foreign banks to seek aid from their governments as a result of the financial crisis of 2007-2009?

- A. Decrease in their exchange rates
- B. Investments in U.S. subprime mortgages
- C. Interest rate spikes
- D. Currency controls

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

91. Which one of these was a major cause of the deep recession and severe unemployment throughout much of Europe that followed the financial crisis of 2007-2009?

- A. Government actions to raise interest rates
- B. Investor speculation
- C. Risk-adverse investor attitudes
- D. Government actions to lower government debt

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

92. Which one of these is generally a key difference between U.S. and foreign commercial banks?

- A. Pooling and investing savings
- B. Accepting investor deposits
- C. Providing debt financing to corporations
- D. Making equity investments in corporations

*AACSB: Reflective Thinking*

*Accessibility: Keyboard Navigation*

*Blooms: Apply*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

## Essay Questions

93. How can an individual save and invest in a corporation?

Households and foreign investors provide most of the savings for corporate financing; financial markets and institutions provide the process and contracts to channel funds from savers to corporations (financial investment) for real investment. Figures 2-1 and 2-2 are excellent graphics for this discussion. Individuals can save and invest in a corporation by lending to, or buying shares in, the financial markets or a financial intermediary such as a bank or mutual fund that subsequently invests in the corporation. When the corporation retains cash and reinvests in the firm's operations, that cash is saved and invested on behalf of the firm's shareholders. The reinvested cash could have been paid out to the shareholders. By not taking the cash, these investors have also reinvested their savings in the corporation.

*AACSB: Reflective Thinking*

*Blooms: Understand*

*Difficulty: 1 Easy*

*Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.*

*Topic: Financial institution functions*

94. Why are secondary market transactions of importance to corporations?

Although corporations do not generate cash flows from secondary market transactions (other than those they initiate), it is the existence of secondary markets that made many investors comfortable enough to invest in their primary market offerings. In other words, if investors felt there would not be an organized, convenient market in which to alter their portfolio of securities, their original investment decisions might be quite different. Also, the secondary market acts as a form of "scorecard" for the decisions of management and the general prospects of the firm. Market values are, in most instances, much more important than book values, thus values in the secondary market give investors and analysts alike the ability to evaluate a firm. These evaluations will also affect future primary market offerings.

*AACSB: Analytic*

*Blooms: Analyze*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Primary and secondary markets*

95. What is meant by over-the-counter trading?

"Over the counter" refers to trading that does not take place on a centralized exchange such as the New York Stock Exchange. For example, trading of securities on NASDAQ is over the counter because NASDAQ is a network of security dealers linked by computers. Although some corporate bonds are traded on the NYSE, most corporate bonds are traded over the counter, as are all U.S. Treasury securities. Foreign exchange trading is also over the counter.

*AACSB: Communication*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

96. Describe the distinguishing characteristics of the major financial markets.

The stock market, or equity market, is the market where the stocks of corporations are issued and traded. Most trading in the shares of large corporations takes place on centralized stock exchanges such as the NYSE. A corporation may also list its shares on several stock exchanges simultaneously. There is also a thriving over-the-counter market in shares. The fixed-income market is the market for bonds and other debt securities. A few corporate debt securities are traded on stock exchanges, but most corporate debt securities and government debt are traded over the counter. The foreign exchange market is the market where different currencies are traded. Most trading takes place in over-the-counter transactions between the major international banks. Another major market is the commodities market, where agricultural commodities, fuels (including crude oil and natural gas), and metals (such as gold, silver, and platinum) are traded on organized exchanges. In addition to these, there are also markets for options and other derivatives, which derive their value from the price of other underlying securities such as stocks or commodities.

*AACSB: Reflective Thinking*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Money and capital markets*



97. What are the advantages of investing indirectly in stocks and bonds via mutual funds and pension funds?

Mutual funds pool savings from many individual investors and then invest in a diversified portfolio of securities. Each individual investor then owns a proportionate share of the mutual fund's portfolio. The advantages of mutual funds for individuals are diversification, professional investment management, and record keeping. In particular, an individual can achieve a widely diversified portfolio at a reasonable cost even when the investment amount is very small. Pension funds are also pooled investments, but are set up by an employer to provide for employees' retirement. Pension funds offer efficient diversification and professional management, too. Additionally, they offer a tax advantage because investment returns are not taxed until withdrawn from the fund.

*AACSB: Analytic*

*Blooms: Analyze*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Types of financial institutions*

98. What are the key differences between a financial intermediary and a financial institution?

Financial intermediaries such as mutual funds and pension funds pool and invest savings in financial assets. Financial institutions such as banks or insurance companies raise money in various ways—for example, by accepting deposits or selling insurance policies. They not only invest in securities but also lend directly to businesses. They also provide various other financial services such as payment and risk management services.

*AACSB: Analytic*

*Blooms: Analyze*

*Difficulty: 2 Medium*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Financial institutions*

99. What are the largest institutional investors in bonds? In stocks?

The largest institutional investors in bonds are insurance companies. Other major institutional investors in bonds are pension funds, mutual funds, and banks and other savings institutions. The largest institutional investors in shares are pension funds, mutual funds, and insurance companies.

*AACSB: Communication*

*Blooms: Remember*

*Difficulty: 1 Easy*

*Learning Objective: 02-02 Understand the basic structure of banks; insurance companies; mutual funds; and pension funds.*

*Topic: Capital markets*

100. What are the functions of financial markets?

Financial markets allow for many necessary and important functions including providing the abilities to transport cash across time, transfer risk, provide liquidity, and allow for greater diversification in investing. Financial markets help channel savings to corporate investment, matching borrowers and lenders. Trading in financial markets provides a wealth of useful information for the financial manager.

*AACSB: Reflective Thinking*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Capital markets*

101. How can the financial manager identify the cost of the capital raised by a corporation?

The cost of capital is the minimum acceptable rate of return on capital investment. It is an opportunity cost, that is, a rate of return that investors could earn in financial markets. For a safe capital investment, the opportunity cost is the interest rate on safe debt securities, such as high-grade corporate bonds. For riskier capital investments, the opportunity cost is the expected rate of return on risky securities, such as investments in the stock market.

*AACSB: Reflective Thinking*

*Blooms: Understand*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Cost of capital-general*

102. Why do nonfinancial corporations need modern financial markets and institutions?

The reason is straightforward: Corporations need access to financing in order to innovate and grow. A modern financial system offers different types of financing, depending on a corporation's age and the nature of its business. A high-tech startup will seek venture capital financing, for example. A mature firm will rely more on bond markets.

*AACSB: Analytic*

*Blooms: Analyze*

*Difficulty: 1 Easy*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

103. How was the role of many bankers in the Financial Crisis of 2007-2009 an example of an agency problem?

An agency problem is a failure of an agent (the banker) to work in the best interest of his or her principals (the bank's shareholders). Typically a result of a poor incentive structure, agency problems played a role in the Financial Crisis of 2007-2009. Bonuses and promotions provided the incentive to promote the sale and resale of subprime mortgages and mortgage-backed securities. As suggested in the last chapter, managers were probably aware that a strategy of originating massive amounts of subprime debt was likely to end badly.

*AACSB: Analytic*

*Blooms: Analyze*

*Difficulty: 3 Hard*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*

104. Investing \$100,000 in additional raw materials today—mostly in palladium—should allow Cryogenic Concepts to increase production and earn an additional \$112,000 next year. This payoff would cover the investment today, plus a 12% return. Palladium is traded in commodity markets. The CFO has studied the history of returns on investments in palladium and believes that investors in that precious metal can reasonably expect a 15% return. Is Cryogenic's investment in palladium a good idea? Why or why not?

This would not be a good investment, as the opportunity cost of capital in this situation (15%) is greater than the expected return (12%). The investment should be made only if the expected return on the project is greater than the opportunity cost of capital.

*AACSB: Analytic*

*Blooms: Analyze*

*Difficulty: 2 Medium*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Expected (required) return*

105. Rhonda and Reggie Hotspur are working hard to save for their children's college educations. They don't need more cash for current consumption but will face big tuition bills in 2020. Should they therefore avoid investing in stocks that pay generous current cash dividends? Explain briefly.

Rhonda and Reggie need not avoid high-dividend stocks. They can reinvest the dividends and keep reinvesting until it's time to pay the tuition bills. They will have to pay taxes on the dividends, however, which could affect their investment strategy.

*AACSB: Analytic*

*Blooms: Analyze*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Stock returns and yields*

106. What is an exchange traded fund? What are some popular choices of exchange traded funds?

Exchange traded funds (ETFs) are portfolios of stocks that can be bought or sold in a single trade. These include Standard & Poor's Depository Receipts (SPDRs, or "spiders"), which are portfolios matching Standard & Poor's stock market indexes. The total amount invested in the spider tracking the benchmark S&P 500 index was about \$94 billion by early 2011. You can also buy DIAMONDS, which track the Dow Jones Industrial Average; QUBES or QQQQs, which track the NASDAQ 100 index; and Vanguard ETFs, which track the Vanguard Total Stock Market index, a basket of almost all the stocks traded in the United States. You can also buy ETFs that track foreign stock markets, bonds, or commodities.

*AACSB: Communication*

*Blooms: Remember*

*Difficulty: 2 Medium*

*Learning Objective: 02-03 Explain the functions of financial markets and institutions.*

*Topic: Financial institution functions*

107. What are subprime mortgages and how were they a part of the Financial Crisis of 2007-2009?

In the early twenty-first century, central banks promoted a policy of cheap money (low interest rates). Banks took advantage of this cheap money to expand the supply of *subprime mortgages* to low-income borrowers. Subprime mortgages are mortgages given to people with a higher probability of default than a typical home buyer. Many banks tempted would-be home buyers with low initial payments, offset by significantly higher payments later. Most subprime mortgages were then bundled with other mortgages into mortgage-backed securities that could be resold. But, instead of selling these securities to investors who could best bear the risk, many banks kept large quantities of the loans on their own books or sold them to other banks. When housing prices began to decline and mortgage default rates began to rise, owners of the mortgage-backed securities began to report massive losses and many teetered on the brink of bankruptcy.

*AACSB: Reflective Thinking*

*Blooms: Understand*

*Difficulty: 3 Hard*

*Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009 and the subsequent eurozone crisis.*

*Topic: Financial distress*