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Economics of Money, Banking & Financial Markets, 5e **(Mishkin)**
Chapter 2 An Overview of the Financial System

2.1 Function of Financial Markets

1) Every financial market has which of the following
characteristics? A) It determines the level of interest rates.
B) It allows common stock to be
traded. C) It allows loans to be made.
D) It channels funds from lenders-savers to borrowers-
spenders. Answer: D
Diff: 1 Type: MC Page Ref: 18
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

2) Financial markets have the basic function of________.

A) getting people with funds to lend together with people who want to borrow funds
B) assuring that the swings in the business cycle are less pronounced
C) assuring that governments need never resort to printing money
D) providing a risk-free repository of spending power
Answer: A
Diff: 1 Type: MC Page Ref: 18
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

3) Financial markets improve economic welfare because
________. A) they channel funds from investors to savers
B) they allow consumers to time their purchase
better C) they weed out inefficient firms
D) eliminate the need for indirect
finance Answer: B
Diff: 2 Type: MC Page Ref: 19

Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

4) Well-functioning financial markets_________.
A) cause inflation

B) eliminate the need for indirect finance
C) cause financial crises
D) produce an efficient allocation of capital
Answer: D
Diff: 3 Type: MC Page Ref: 19
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

5) A breakdown of financial markets can result in_________.
A) financial stability
B) rapid economic
growth C) political
instability D) stable
prices Answer: C
Diff: 2 Type: MC Page Ref: 18-19
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

6) The principal lender-savers are_________.
A) governments
B) businesses
C) households
D) foreigners
Answer: C
Diff: 1 Type: MC Page Ref: 19
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

7) Which of the following can be described as direct
finance? A) You take out a mortgage from your local bank.
B) You borrow $2500 from a friend.
C) You buy shares of common stock in the secondary market.
D) You buy shares in a mutual fund.
Answer: B
Diff: 2 Type: MC Page Ref: 18-19
Skill: Applied
Objective List: 2.1 Summarize the basic function performed by financial markets

8) Assume that you borrow $2000 at 10 percent annual interest to finance a new business project. For this loan to be profitable, the minimum amount this project must generate in annual earnings is_________.
A) $400 B)
$201 C)
$200 D)
$199
Answer: B
Diff: 2 Type: MC Page Ref: 18-19
Skill: Applied
Objective List: 2.1 Summarize the basic function performed by financial markets

9) You can borrow $5000 to finance a new business venture. This new venture will generate annual earnings of $251. The maximum interest rate that you would pay on the borrowed funds and still increase your income is_________.
A) 25 percent
B) 12.5 percent
C) 10 percent
D) 5 percent
Answer: D
Diff: 3 Type: MC Page Ref: 19
Skill: Applied
Objective List: 2.1 Summarize the basic function performed by financial markets

10) Which of the following can be described as involving direct finance? A) A corporation issues new shares of stock.
B) People buy shares in a mutual fund.
C) A pension fund manager buys a short-term corporate security in the secondarymarket.
D) An insurance company buys shares of common stock in the over-the-counter markets.
Answer: A
Diff: 3 Type: MC Page Ref: 18
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

11) Which of the following can be described as involving direct finance? A) A corporation takes out loans from a bank.
B) People buy shares in a mutual fund.
C) A corporation buys a short-term corporate security in a secondary market.
D) People buy shares of common stock in the primary markets.
Answer: D
Diff: 3 Type: MC Page Ref: 18
Skill: Applied
Objective List: 2.1 Summarize the basic function performed by financial markets

12) Which of the following can be described as involving indirect finance? A) You make a loan to your neighbor.
B) A corporation buys a share of common stock issued by another corporation in the primary market.
C) You buy a Canadian Treasury bill from the Bank of Canada. D) You make a deposit at a bank.
Answer: D
Diff: 3 Type: MC Page Ref: 18
Skill: Applied
Objective List: 2.1 Summarize the basic function performed by financial markets

13) Securities are__________for the person who buys them, but are__________for the individual or firm that issues them.
A) assets; liabilities
B) liabilities; assets
C) negotiable; nonnegotiable
D) nonnegotiable; negotiable
Answer: A
Diff: 2 Type: MC Page Ref: 18
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

14) With__________finance, borrowers obtain funds from lenders by selling them securities in the financial markets.
A) active
B) determined
C) indirect D)
direct Answer:
D
Diff: 2 Type: MC Page Ref: 18
Skill: Applied
Objective List: 2.1 Summarize the basic function performed by financial markets

15) How do financial intermediaries play an important role in the economy?
Answer: Financial intermediaries play an important role in the economy because they provide liquidity services, they lower transaction costs through economies of scale, they reduce the risk exposure of investors through risk sharing, and they solve the asymmetric information problems of adverse selection and moral hazard. By doing this, they allow small savers and borrowers to benefit from the existence of financial markets and its instruments. They also improve economic efficiency because they help financial markets to channel funds from lenders-savers to people with productive investment opportunities.
Diff: 3 Type: SA Page Ref: 18-19
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

2.2 Structure of Financial Markets

1) Which of the following statements about the characteristics of debt and equity is false?
A) They can both be long-term financial instruments.
B) They can both be short-term financial instruments.
C) They both involve a claim on the issuer's income.
D) They both enable a corporation to raise funds.
Answer: B
Diff: 2 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

2) Which of the following statements about the characteristics of debt and equities is true? A) They can both be long-term financial instruments.
B) Bond holders are residual claimants.
C) The income from bonds is typically more variable than that from equities. D) Bonds pay dividends.
Answer: A
Diff: 2 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

3) Which of the following statements about financial markets and securities is true?
A) A bond is a long-term security that promises to make periodic payments called dividends to the firm's residual claimants.
B) A debt instrument is intermediate term if its maturity is less than one year.
C) A debt instrument is intermediate term if its maturity is ten years or longer.
D) The maturity of a debt instrument is the number of years (term) to that instrument's expiration date.
Answer: D
Diff: 2 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

4) Which of the following is an example of an intermediate-term debt? A) A thirty-year mortgage
B) A sixty-month car loan
C) A six month loan from a finance company
D) A Treasury bond
Answer: B
Diff: 2 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

5) If the maturity of a debt instrument is less than one year, the debt is called ________. A) short-term
B) intermediate-term
C) long-term
D) prima-term
Answer: A
Diff: 1 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

6) Long-term debt has a maturity that is ________. A) between one and ten years
B) less than a year
C) between five and ten years
D) ten years or longer
Answer: D
Diff: 1 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

7) When I purchase________, I own a portion of a firm and have the right to vote on issues important to the firm and to elect its directors.
A) bonds
B) bills C)
notes D)
stock
Answer: D
Diff: 1 Type: MC Page Ref: 20
Skill: Applied
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

8) Which of the following benefit directly from any increase in the corporation's profitability? A) A bond holder
B) A commercial paper holder
C) A shareholder
D) A T-bill
holder Answer: C
Diff: 2 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

9) A financial market in which previously issued securities can be resold is called a _________ market.
A) primary
B) secondary
C) tertiary
D) used securities
Answer: B
Diff: 1 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

10) When an investment bank_________securities, it guarantees a price for a corporation's securities and then sells them to the public.
A) underwrites
B) undertakes
C) overwrites
D) overtakes
Answer: A
Diff: 1 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

11) Which of the following is not a secondary market? A) Foreign exchange market
B) Futures market
C) Options market
D) Primary market
Answer: D
Diff: 1 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

12) _________work in the secondary markets matching buyers with sellers of securities. A) Dealers
B) Underwriters
C) Brokers
D) Claimants
Answer: C
Diff: 1 Type: MC Page Ref: 20
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

13) A corporation acquires new funds only when its securities are sold in the ________. A) primary market by an investment bank
B) primary market by a stock exchange broker
C) secondary market by a securities dealer D)
secondary market by a commercial bank
Answer: A
Diff: 2 Type: MC Page Ref: 20
Skill: Applied
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

14) A corporation acquires new funds only when its securities are sold in the ________. A) secondary market by an investment bank
B) primary market by an investment bank
C) secondary market by a stock exchange
broker D) secondary market by a commercial
bank Answer: B
Diff: 2 Type: MC Page Ref: 20
Skill: Applied
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

15) An important function of secondary markets is to________.
A) make it easier to sell financial instruments to raise funds
B) raise funds for corporations through the sale of
securities C) make it easier for governments to raise taxes
D) create a market for newly constructed
houses Answer: A
Diff: 2 Type: MC Page Ref: 21
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

16) Secondary markets make financial instruments more ________. A) solid
B) vapid
C) liquid
D) risky
Answer: C
Diff: 1 Type: MC Page Ref: 21
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

17) A liquid asset is_________.
A) an asset that can easily and quickly be sold to raise cash
B) a share of an ocean resort
C) difficult to resell
D) always sold in an over-the-counter market
Answer: A
Diff: 1 Type: MC Page Ref: 21
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

18) The higher a security's price in the secondary market the_________funds a firm can raise by selling securities in the_________market.
A) more; primary
B) more; secondary
C) less; primary D)
less; secondary
Answer: A
Diff: 1 Type: MC Page Ref: 21
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

19) A financial market in which only short-term debt instruments are traded is called the

____
market. A) bond
B) money
C) capital
D) stock
Answer: B
Diff: 1 Type: MC Page Ref: 21
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

20) Corporations receive funds when their stock is sold in the primary market. Why do corporations pay attention to what is happening to their stock in the secondary market? Answer: The existence of the secondary market makes their stock more liquid and the price in the secondary market sets the price that the corporation would receive if they choose to sell more stock in the primary market.
Diff: 2 Type: SA Page Ref: 21
Skill: Applied
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

21) Describe the two methods of organizing a secondary market.
Answer: A secondary market can be organized as an exchange where buyers and sellers meet in one central location to conduct trades. An example of an exchange is the New York Stock Exchange. A secondary market can also be organized as an over-the-counter market. In this type of market, dealers in different locations buy and sell securities to anyone who comes to them and is willing to accept their prices. An example of an over-the-counter market is the federal funds market.
Diff: 2 Type: SA Page Ref: 21
Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

22) Describe the difference between the money market and the capital market.
Answer: The money market in which short-term debt instruments are traded. The capital market is the market in which longer-term debt is traded. Diff: 1 Type: SA Page Ref: 21

Skill: Recall
Objective List: 2.2 Explain why financial markets are classified as debt and equity markets etc.

2.3 Financial Market Instruments

1) Prices of money market instruments undergo the least price fluctuations because of_________.
A) the short terms to maturity for the securities
B) the heavy regulations in the industry
C) the price ceiling imposed by government
regulators D) the lack of competition in the market
Answer: A
Diff: 3 Type: MC Page Ref: 22
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

2) Treasury bills pay no interest but are sold at a_________. That is, you will pay a lower purchase price than the amount you receive at maturity.
A) premium
B) collateral
C) default
D) discount
Answer: D
Diff: 2 Type: MC Page Ref: 22
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

3) Treasury bills are considered the safest of all money market instruments because there is no risk of________.
A) defeat B)
default C)
desertion
D) demarcation
Answer: B
Diff: 2 Type: MC Page Ref: 22
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

4) A debt instrument sold by a bank to its depositors that pays annual interest of a given amount and at maturity pays back the original purchase price is called________.
A) commercial paper
B) a negotiable certificate of deposit
C) a municipal bond
D) federal funds
Answer: B
Diff: 2 Type: MC Page Ref: 23
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

5) A short-term debt instrument issued by well-known corporations is called________.
A) commercial paper
B) corporate bonds
C) municipal bonds
D) commercial
mortgages Answer: A
Diff: 1 Type: MC Page Ref: 23
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

6) ________are short-term loans in which Treasury bills serve as collateral.
A) Repurchase agreements
B) Negotiable certificates of deposit
C) Overnight funds
D) Government agency securities
Answer: A
Diff: 1 Type: MC Page Ref: 23
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

7) Collateral is_________the lender receives if the borrower does not pay back the loan.
A) a liability
B) an asset C)
a present D)
an offering
Answer: B
Diff: 1 Type: MC Page Ref: 23
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

8) Overnight funds are ________.

A) funds raised by the federal government in the bond market
B) loans made by the Bank of Canada to banks
C) loans made by banks to the Bank of Canada
D) loans made by banks to each other
Answer: D
Diff: 2 Type: MC Page Ref: 23
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

9) Which of the following are short-term financial
instruments? A) A repurchase agreement
B) A share of Walt Disney Corporation stock C)
A Treasury note with a maturity of four years
D) A residential mortgage
Answer: A
Diff: 2 Type: MC Page Ref: 23
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

10) Which of the following instruments are traded in a money market?
A) Provincial government bonds
B) Treasury bills
C) Corporate bonds
D) Government agency securities
Answer: B
Diff: 2 Type: MC Page Ref: 22
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

11) Which of the following instruments are traded in a money market?
A) Bank commercial loans
B) Commercial paper
C) Provincial government
bonds D) Residential mortgages
Answer: B
Diff: 1 Type: MC Page Ref: 23
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

12) Which of the following instruments is not traded in a money
market? A) Residential mortgages
B) Treasury Bills
C) Negotiable bank certificates of
deposit D) Commercial paper
Answer: A
Diff: 1 Type: MC Page Ref: 22
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

13) Bonds issued by corporations are called_________bonds.
A) corporate
B) Treasury C)
municipal D)
commercial
Answer: A
Diff: 1 Type: MC Page Ref: 25
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

14) Equity and debt instruments with maturities greater than one year are called _________
market instruments.
A) capital
B) money C)
federal D)
benchmark
Answer: A
Diff: 1 Type: MC Page Ref: 25
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

15) Explain why Government of Canada Treasury Bills are considered as a financial instrument with very low risk.
Answer: Government of Canada Treasury Bills are considered low risk, because they are the most actively traded money market instruments; their original maturity is no more than 12 months. Moreover, there is almost no probability of default. The federal government is always able to meet its debt obligations as it can raise taxes to service its debt.
Diff: 2 Type: SA Page Ref: 22
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

16) Explain why only the largest and most trustworthy corporations issue the financial instruments known as *commercial paper*?
Answer: Commercial paper is an unsecured short-term debt instrument issued either in Canadian dollars or other currencies. Since it is unsecured, only the largest corporations and banks are able to issue commercial paper so that the market can trust them and invest in their issue. It is highly unlikely that an investor would trust a small unknown firm and finance it with an unsecured loan.
Diff: 2 Type: SA Page Ref: 23
Skill: Recall
Objective List: 2.3 Describe the principal money market and capital market instruments

2.4 Internationalization of Financial Markets

1) One reason for the extraordinary growth of foreign financial markets is ________. A) decreased trade
B) increases in the pool of savings in foreign countries
C) the recent introduction of the foreign bond
D) slower technological innovation in foreign markets
Answer: B
Diff: 2 Type: MC Page Ref: 27
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

2) Bonds that are sold in a foreign country and are denominated in the country's currency in which they are sold are known as_________.
A) foreign bonds
B) Eurobonds C)
equity bonds D)
country bonds
Answer: A
Diff: 1 Type: MC Page Ref: 27
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

3) Bonds that are sold in a foreign country and are denominated in a currency other than that of the country in which it is sold are known as________.
A) foreign bonds
B) Eurobonds C)
equity bonds D)
country bonds
Answer: B
Diff: 2 Type: MC Page Ref: 27
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

4) If Microsoft sells a bond in London and it is denominated in dollars, the bond is a________.
A) Eurobond
B) foreign bond
C) British bond
D) currency
bond Answer: A
Diff: 1 Type: MC Page Ref: 27
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

5) U.S. dollar deposits in foreign banks outside the U.S. or in foreign branches of U.S. banks are called________.
A) Atlantic dollars
B) Eurodollars C)
foreign dollars D)
outside dollars
Answer: B
Diff: 1 Type: MC Page Ref: 27
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

6) Distinguish between a foreign bond and a Eurobond.
Answer: A foreign bond is sold in a foreign country and priced in that country's currency A Eurobond is sold in a foreign country and priced in a currency that is not that country's currency
Diff: 1 Type: SA Page Ref: 27
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

2.5 Function of Financial Intermediaries: Indirect Finance

1) The process of indirect finance using financial intermediaries is called_________.
A) direct lending
B) financial intermediation
C) resource allocation
D) financial liquidation
Answer: B
Diff: 1 Type: MC Page Ref: 30
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

2) The time and money spent in carrying out financial transactions are called
________. A) economies of scale
B) financial intermediation
C) liquidity services
D) transaction
costs Answer: D
Diff: 1 Type: MC Page Ref: 31
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

3) Economies of scale enable financial institutions to
________. A) reduce transactions costs
B) avoid the asymmetric information problem
C) avoid adverse selection problems
D) reduce moral hazard
Answer: A
Diff: 1 Type: MC Page Ref: 31
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

4) An example of economies of scale in the provision of financial services is_________.
A) investing in a diversified collection of assets
B) providing depositors with a variety of savings certificates
C) spreading the cost of borrowed funds over many customers
D) spreading the cost of writing a standardized contract over many
borrowers Answer: D
Diff: 2 Type: MC Page Ref: 31
Skill: Applied
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

5) Financial intermediaries provide customers with liquidity services. Liquidity services ________.
A) make it easier for customers to conduct transactions
B) allow customers to have a cup of coffee while waiting in the lobby
C) are a result of the asymmetric information problem
D) are another term for asset transformation Answer: A
Diff: 2 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

6) The process where financial intermediaries create and sell low-risk assets and use the proceeds to purchase riskier assets is known as_________.
A) risk sharing
B) risk aversion
C) risk neutrality
D) risk selling
Answer: A
Diff: 1 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

7) The process of asset transformation refers to the conversion of_________.
A) safer assets into risky assets
B) safer assets into safer liabilities
C) risky assets into safer assets D) risky assets into risky liabilities
Answer: C
Diff: 2 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

8) Reducing risk through the purchase of assets whose returns do not always move together is ________.
A) diversification
B) intermediation
C) intervention D) discounting
Answer: A
Diff: 1 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

9) The concept of diversification is captured by the statement
________. A) don't look a gift horse in the mouth
B) don't put all your eggs in one
basket C) it never rains, but it pours
D) make hay while the sun shines
Answer: B
Diff: 1 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

10) Risk sharing is profitable for financial institutions due to________.
A) low transactions costs
B) asymmetric information
C) adverse selection
D) moral hazard
Answer: A
Diff: 2 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

11) Typically, borrowers have superior information relative to lenders about the potential returns and risks associated with an investment project. The difference in information is called
________.
A) moral selection
B) risk sharing
C) asymmetric information
D) adverse hazard Answer:
C
Diff: 2 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

12) If bad credit risks are the ones who most actively seek loans and, therefore, receive them from financial intermediaries, then financial intermediaries face the problem of
________. A) moral hazard
B) adverse selection
C) free-riding
D) costly state verification
Answer: B
Diff: 2 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

13) The problem created by asymmetric information before the transaction occurs is called ________, while the problem created after the transaction occurs is called ________. A) adverse selection; moral hazard
B) moral hazard; adverse selection
C) costly state verification; free-riding
D) free-riding; costly state verification Answer: A
Diff: 2 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

14) Adverse selection is a problem associated with equity and debt contracts arising from ________.
A) the lender's relative lack of information about the borrower's potential returns and risks of his investment activities
B) the lender's inability to legally require sufficient collateral to cover a 100 percent loss if the borrower defaults
C) the borrower's lack of incentive to seek a loan for highly risky investments D) the borrower's lack of good options for obtaining funds
Answer: A
Diff: 2 Type: MC Page Ref: 32
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

15) An example of the problem of_________is when a corporation uses the funds raised from selling bonds to fund corporate expansion to pay for Caribbean cruises for all of its employees and their families.
A) adverse selection
B) moral hazard C) risk sharing
D) credit risk
Answer: B
Diff: 3 Type: MC Page Ref: 33
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

16) Typically, borrowers have superior information relative to lenders about the potential returns and risks associated with an investment project. The difference in information is called ________, and it creates the_________problem.
A) asymmetric information; risk sharing
B) asymmetric information; adverse
selection C) adverse selection; risk sharing
D) moral hazard; adverse
selection Answer: B
Diff: 2 Type: MC Page Ref: 33
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

17) Studies of the major developed countries show that when businesses go looking for funds to finance their activities they usually obtain these funds from_________.
A) government agencies
B) equities markets
C) financial intermediaries
D) bond markets Answer:
C
Diff: 2 Type: MC Page Ref: 31
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

18) The countries that have made the least use of securities markets are_________and ________; in these two countries finance from financial intermediaries has been almost ten times greater than that from securities markets.
A) Germany; Japan
B) Germany; Great Britain
C) Great Britain; Canada
D) Canada; Japan Answer:
A
Diff: 2 Type: MC Page Ref: 31
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

19) Although the dominance of_________over_________is clear in all countries, the relative importance of bond versus stock markets differs widely.
A) financial intermediaries; securities markets
B) financial intermediaries; government
agencies C) government agencies; financial
intermediaries D) government agencies;
securities markets Answer: A
Diff: 3 Type: MC Page Ref: 31
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

20) Because there is an imbalance of information in a lending situation, we must deal with the problems of adverse selection and moral hazard. Define these terms and explain how financial intermediaries can reduce these problems.
Answer: Adverse selection is the asymmetric information problem that exists before the transaction occurs. For lenders, it is the difficulty in judging a good credit risk from a bad credit risk. Moral hazard is the asymmetric information problem that exists after the transaction occurs. For lenders, it is the difficulty in making sure the borrower uses the funds appropriately. Financial intermediaries can reduce adverse selection through intensive screening and can reduce moral hazard by monitoring the borrower.
Diff: 2 Type: SA Page Ref: 32-33
Skill: Applied
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

2.6 Types of Financial Intermediaries

1) Financial institutions that accept deposits and make loans are called _________
institutions. A) investment
B) contractual
savings C) depository
D) underwriting
Answer: C
Diff: 1 Type: MC Page Ref: 34
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

2) Depository institutions include_________.

A) banks, mutual funds, and insurance companies
B) banks, trust and mortgage loan companies, and credit unions
C) finance companies, mutual funds, and money market funds
D) pension funds, mutual funds, and banks
Answer: B
Diff: 1 Type: MC Page Ref: 34
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

3) Which of the following is a depository
institution? A) A life insurance company
B) A credit union
C) A pension fund
D) A mutual fund
Answer: B
Diff: 1 Type: MC Page Ref: 34
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

4) Which of the following financial intermediaries is not a depository
institution? A) A savings and loan association
B) A commercial bank
C) A credit union
D) A finance company
Answer: D
Diff: 1 Type: MC Page Ref: 34
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

5) The primary assets of credit unions are________.
A) municipal bonds
B) business loans
C) consumer loans
D) mortgages
Answer: C
Diff: 1 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

6) The primary liabilities of a chartered bank are
________. A) bonds
B) mortgages
C) deposits
D) commercial paper
Answer: C
Diff: 1 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

7) The primary liabilities of depository institutions are_________.
A) premiums from policies
B) shares
C) deposits
D) bonds
Answer: C
Diff: 1 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

8) _________institutions are financial intermediaries that acquire funds at periodic intervals on a contractual basis.
A) Investment
B) Contractual savings
C) Thrift
D) Depository
Answer: B
Diff: 1 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

9) Which of the following is a contractual savings institution?
A) A life insurance company
B) A credit union
C) A savings and loan association
D) A mutual fund
Answer: A
Diff: 1 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

10) Contractual savings institutions include_________.
A) mutual savings banks
B) money market mutual funds
C) commercial banks
D) life insurance companies
Answer: D
Diff: 1 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

11) Which of the following are not contractual savings institutions? A) Life insurance companies
B) Credit unions
C) Pension funds
D) Government retirement funds
Answer: B
Diff: 1 Type: MC Page Ref: 35-36
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

12) Which of the following is not a contractual savings institution? A) A life insurance company
B) A pension fund
C) A finance association
D) A property and casualty insurance company
Answer: C
Diff: 1 Type: MC Page Ref: 35-36
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

13) The primary assets of a pension fund are__________.
A) money market instruments
B) corporate bonds and stock
C) consumer and business loans
D) mortgages
Answer: B
Diff: 1 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

14) Which of the following are investment intermediaries? A) Life insurance companies
B) Mutual funds
C) Pension funds
D) Government retirement funds
Answer: B
Diff: 1 Type: MC Page Ref: 37
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

15) An investment intermediary that lends funds to consumers is
________. A) a finance company
B) an investment bank
C) a finance fund
D) a consumer company
Answer: A
Diff: 1 Type: MC Page Ref: 37
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

16) The primary assets of a finance company are________.
A) municipal bonds
B) corporate stocks and bonds
C) consumer and business loans
D) mortgages
Answer: C
Diff: 2 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

17) ________are financial intermediaries that acquire funds by selling shares to many individuals and using the proceeds to purchase diversified portfolios of stocks and bonds.
A) Mutual funds
B) Investment banks
C) Finance
companies D) Credit
unions Answer: A
Diff: 2 Type: MC Page Ref: 37
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

18) An important feature of money market mutual fund shares is________.
A) deposit insurance
B) they offer deposit-type accounts
C) the ability to borrow against shareholdings
D) claims on shares of corporate stock
Answer: B
Diff: 2 Type: MC Page Ref: 37
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

19) The primary assets of money market mutual funds are
________. A) stocks
B) bonds
C) money market instruments
D) deposits
Answer: C
Diff: 2 Type: MC Page Ref: 35
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

20) The liquidity of assets in contractual savings institutions
________. A) is an important consideration
B) is not an important consideration
C) is restricted
D) is an undertaking
Answer: B
Diff: 1 Type: MC Page Ref: 39
Skill: Recall
Objective List: 2.1 Summarize the basic function performed by financial markets

2.7 Regulation of the Financial System

1) Which of the following is not a goal of financial
regulation? A) Ensuring the soundness of the financial system
B) Reducing moral hazard
C) Reducing adverse selection
D) Ensuring that investors never suffer losses
Answer: D
Diff: 2 Type: MC Page Ref: 37
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

2) Increasing the amount of information available to investors helps to reduce the problems of
_________and_________in the financial
markets. A) adverse selection; moral hazard
B) adverse selection; risk sharing
C) moral hazard; transactions costs
D) adverse selection; economies of
scale Answer: A
Diff: 2 Type: MC Page Ref: 37
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

3) A goal of the Ontario Securities Commission is to reduce problems arising from________.
A) competition
B) banking
panics C) risk
D) asymmetric
information Answer: D
Diff: 2 Type: MC Page Ref: 37-38
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

4) The purpose of the disclosure requirements is to________.
A) increase the information available to investors
B) prevent bank panics
C) improve monetary control
D) protect investors against financial losses
Answer: A
Diff: 2 Type: MC Page Ref: 39
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

5) Government regulations to reduce the possibility of financial panic include all of the following except________.
A) transactions costs
B) restrictions on assets and activities
C) disclosure
D) deposit insurance
Answer: A
Diff: 1 Type: MC Page Ref: 38-39
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

6) The Canada Deposit Insurance Corporation regulates________.
A) brokerage firms
B) banks
C) credit unions
D) mutual funds
Answer: B
Diff: 2 Type: MC Page Ref: 38
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

7) In order to reduce risk and increase the safety of financial institutions, commercial banks and other depository institutions are prohibited from________.
A) owning corporate bonds
B) making real estate loans
C) making personal loans
D) owning common stock
Answer: D
Diff: 2 Type: MC Page Ref: 39
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

8) The primary purpose of deposit insurance is to________.
A) improve the flow of information to investors
B) prevent banking panics
C) protect bank shareholders against losses
D) protect bank employees from unemployment
Answer: B
Diff: 2 Type: MC Page Ref: 39
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

9) Asymmetric information is a universal problem. This would suggest that financial regulations ________.
A) in industrial countries are an unqualified
failure B) differ significantly around the world
C) in industrialized nations are
similar D) are unnecessary
Answer: C
Diff: 3 Type: MC Page Ref: 40
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

10) How do regulators help to ensure the soundness of financial intermediaries? Answer: Regulators restrict who can set up as a financial intermediary, conduct regular examinations, restrict assets, and provide insurance to help ensure the soundness of financial intermediaries.
Diff: 2 Type: SA Page Ref: 37-39
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries

11) How does regulation reduce the problems of adverse selection and moral hazard? What regulations are or have been used to protect the public from panics?
Answer: Regulation attempts to reduce asymmetric information and financial instability. Financial stability is promoted by regulations restricting entry, disclosure and/or examination, restrictions on assets and risk taking, deposit insurance, limits on competition, and interest rate controls.
Diff: 3 Type: SA Page Ref: 37-39
Skill: Recall
Objective List: 2.4 Express why the government regulates financial markets and financial intermediaries