Chapter 2
An Overview of the Financial System

■ Multiple Choice

1) Every financial market has the following characteristic:
(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
Question Status: Previous Edition

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) both (a) and (b) of the above.
(e) both (b) and (c) of the above.

Answer: A
Question Status: Previous Edition

3) Financial markets improve economic welfare because
(a) they allow funds to move from those without productive investment opportunities to those who have such opportunities.
(b) they allow consumers to time their purchase better.
(c) they weed out inefficient firms.
(d) they do each of the above.
(e) they do (a) and (b) of the above.

Answer: E
Question Status: Previous Edition

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.
(e) promote political instability.

Answer: D
Question Status: New

5) A breakdown of financial markets can result in
(a) an efficient allocation of capital.
(b) rapid economic growth.
(c) political instability.
(d) stable prices.
(e) financial stability.
Answer: C
Question Status: New

6) 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) A pension fund lends money to General Motors.
(d) You buy shares in a mutual fund.
(e) None of the above.
Answer: B
Question Status: Study Guide

7) Assume that you borrow $2000 at 10% 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.
(e) $101.
Answer: B
Question Status: New

8) 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%.
(b) 12.5%.
(c) 10%.
(d) 5%.
(e) 0.5%.
Answer: D
Question Status: New

9) Which of the following can be described as involving direct finance?
(a) A corporation takes out a loan from a bank.
(b) People buy shares in a mutual fund.
(c) A corporation buys a short-term security issued by another corporation.
(d) An insurance company buys shares of common stock in the over-the-counter markets.
(e) None of the above.
Answer: C
Question Status: Previous Edition

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 secondary market.
(d) An insurance company buys shares of common stock in the over-the-counter markets.

Answer: A
Question Status: Previous Edition

11) Which of the following can be described as involving direct finance?
(a) A corporation issues new shares of stock.
(b) A corporation buys a short-term security issued by another corporation.
(c) A pension fund manager buys commercial paper in the secondary market.
(d) Both (a) and (b) of the above.
(e) Both (b) and (c) of the above.

Answer: D
Question Status: Previous Edition

12) Which of the following can be described as involving direct finance?
(a) A corporation issues new shares of stock through an investment bank.
(b) A corporation buys a short-term security paper issued by another corporation.
(c) A pension fund manager buys commercial paper in the primary market.
(d) All of the above.
(e) Both (b) and (c) of the above.

Answer: D
Question Status: Previous Edition

13) 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) An insurance company buys shares of common stock in the primary markets.

Answer: D
Question Status: Previous Edition

14) Which of the following can be described as involving direct finance?
(a) A corporation's stock is traded in an over-the-counter market.
(b) People buy shares in a mutual fund.
(c) A pension fund manager buys a short-term corporate security in the secondary market.
(d) An insurance company buys shares of common stock in the over-the-counter markets.
(e) None of the above.

Answer: E
Question Status: Previous Edition

15) Which of the following can be described as involving direct finance?
(a) A corporation’s stock is traded in an over-the-counter market.
(b) A corporation buys a short-term security issued by another corporation.
(c) A pension fund manager buys a short-term corporate security from the issuing corporation.
(d) Both (a) and (b) of the above.
(e) Both (b) and (c) of the above.
Answer: E
Question Status: Previous Edition

16) Which of the following can be described as involving direct finance?
(a) A corporation issues new shares of stock.
(b) A corporation buys a short-term security issued by another corporation.
(c) A pension fund manager buys a short-term security from the issuing corporation.
(d) All of the above.
(e) Both (b) and (c) of the above.
Answer: D
Question Status: Previous Edition

17) 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.
(c) You buy a U.S. Treasury bill from the U.S. Treasury.
(d) You make a deposit at a bank.
Answer: D
Question Status: Previous Edition

18) Which of the following can be described as involving indirect 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 security issued by another corporation.
(d) Both (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

19) Which of the following can be described as involving indirect 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 secondary market.
(d) Both (a) and (b) of the above.
(e) Both (b) and (c) of the above.
Answer: E
Question Status: Previous Edition

20) Which of the following can be described as involving indirect finance?
(a) A corporation issues new shares of stock.
(b) A corporation buys a short-term security issued by another corporation.
(c) A pension fund manager buys a short-term corporate security in the secondary market.
(d) Both (a) and (b) of the above.

Answer: C
Question Status: Previous Edition

21) Which of the following can be described as involving indirect finance?
(a) A bank buys a U.S. Treasury bill from one of its depositors.
(b) A corporation buys a short-term security issued by another corporation.
(c) A pension fund manager buys a short-term corporate security the primary market.
(d) Both (b) and (c) of the above.

Answer: A
Question Status: Previous Edition

22) Which of the following can be described as involving indirect 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) All of the above.
(e) Only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

23) Which of the following can be described as involving indirect finance?
(a) People buy shares in a mutual fund.
(b) A pension fund manager buys a short-term corporate security in the secondary market.
(c) A corporation's stock is issued in an over-the-counter market.
(d) All of the above.
(e) Only (a) and (b) of the above.

Answer: E
Question Status: Previous Edition

24) Which of the following can be described as involving indirect finance?
(a) A corporation's stock is traded in an over-the-counter market.
(b) A corporation buys a short-term security issued by another corporation.
(c) A pension fund manager buys a short-term security from the issuing corporation.
(d) Both (a) and (b) of the above.

Answer: A
Question Status: Previous Edition

25) Which of the following can be described as involving indirect finance?

(a) A corporation issues new shares of stock.
(b) A corporation buys a short-term security issued by another corporation.
(c) A bank buys a U.S. Treasury bill from one of its depositors.
(d) All of the above.
(e) Both (b) and (c) of the above.

Answer: C
Question Status: Previous Edition

26) Which of the following can be described as involving indirect finance?

(a) You make a loan to your neighbor.
(b) You buy a U.S. Treasury bill from the bank.
(c) You buy a U.S. Treasury bill from the U.S. Treasury.
(d) A corporation buys a short-term security issued by another corporation.

Answer: B
Question Status: Previous Edition

27) Which of the following are securities?

(a) A corporate bond
(b) A share of Texaco common stock
(c) A Treasury bill
(d) Each of the above
(e) Only (a) and (b) of the above

Answer: D
Question Status: Previous Edition

28) Which of the following statements about the characteristics of debt and equity is untrue?

(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.
(e) None of the above.

Answer: B
Question Status: Previous Edition

29) Which of the following statements about the characteristics of debt and equity are true?

(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) Both (a) and (b) of the above.
(e) Both (a) and (c) of the above.

Answer: E
Question Status: Previous Edition

30) Which of the following statements about the characteristics of debt and equity are true?
(a) They can both be long-term financial instruments.
(b) They both involve a claim on the issuer's income.
(c) They both enable a corporation to raise funds.
(d) All of the above.
(e) Only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

31) Which of the following statements about the characteristics of debt and equity are true?
(a) They can both be long-term financial instruments.
(b) They can both be short-term financial instruments.
(c) Debt is a claim on the issuer's assets, but equity is a claim on the issuer's income.
(d) Both (a) and (b) of the above.
(e) Both (a) and (c) of the above.

Answer: A
Question Status: Previous Edition

32) Which of the following statements about financial markets and securities are true?
(a) A bond is a debt security that promises to make payments for a specified period of time.
(b) The maturity of a debt instrument is the time (term) to that instrument's expiration date.
(c) A debt instrument is short term if its maturity is less than one year.
(d) All of the above are true.

Answer: D
Question Status: Previous Edition

33) Which of the following statements about financial markets and securities are 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 long term if its maturity is ten years or longer.
(c) The maturity of a debt instrument is the number of years (term) to that instrument's expiration date.
(d) All of the above are true.
(e) Both (a) and (c) are correct.

Answer: E
Question Status: Revised

34) 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.
(e) None of the above.

Answer: A
Question Status: Study Guide

35) Which of the following statements about financial markets and securities are 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 long 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.
(e) Both (a) and (d) are correct.

Answer: E
Question Status: Revised

36) Which of the following statements about financial markets and securities are true?
(a) A bond is a debt security that promises to make payments for a specified period of time.
(b) Equities often make periodic payments called dividends and are considered to be long-term securities because they have no maturity date.
(c) A debt instrument is short term if its maturity is less than ten years.
(d) All of the above are true.
(e) Only (a) and (b) of the above are true.

Answer: E
Question Status: Previous Edition

37) Which of the following statements about financial markets and securities are true?
(a) A debt instrument is short term if its maturity is between one and ten years.
(b) Equities often make periodic payments called dividends and are considered to be long-term securities because they have no maturity date.
(c) A debt instrument is long term if its maturity is more than one year.
(d) Only (a) and (b) of the above are true.
(e) Only (b) and (c) of the above are true.

Answer: B
Question Status: Previous Edition

38) 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
Question Status: Previous Edition

39) Forty or so dealers establish a "market" in these securities by standing ready to buy and sell them.
(a) Secondary stocks
(b) Surplus stocks
(c) U.S. government bonds
(d) Common stocks

Answer: C
Question Status: Previous Edition

40) Which of the following are primary markets?
(a) The New York Stock Exchange
(b) The U.S. government bond market
(c) The over-the-counter stock market
(d) The options markets
(e) None of the above
Answer: E
Question Status: Previous Edition

41) Which of the following are secondary markets?
(a) The New York Stock Exchange
(b) The U.S. government bond market
(c) The over-the-counter stock market
(d) The options markets
(e) All of the above
Answer: E
Question Status: Previous Edition

42) An important function of secondary markets is to
(a) make it easier to sell financial instruments to raise cash.
(b) raise funds for corporations through the sale of securities.
(c) create a market for bank demand deposits.
(d) create a market for newly constructed houses.
(e) make it easier for governments to raise taxes.
Answer: A
Question Status: New

43) Secondary markets make financial instruments more
(a) solid.
(b) fluid.
(c) liquid.
(d) risky.
(e) vapid.
Answer: C
Question Status: New

44) The higher a security's price in the secondary market
(a) the more funds a firm can raise by selling securities in the primary market.
(b) the more funds a firm can raise by selling securities in the secondary market.
(c) the less funds a firm can raise by selling securities in the primary market.
(d) the less funds a firm can raise by selling securities in the secondary market.
(e) secondary market prices have no effect on the funds a firm can raise.
Answer: A
Question Status: New

45) An important financial institution that assists in the initial sale of securities in the primary market is the

(a) investment bank.
(b) commercial bank.
(c) stock exchange.
(d) brokerage house.

Answer: A
Question Status: Previous Edition

46) A corporation acquires new funds only when its securities are sold

(a) in the primary market by an investment bank.
(b) in the primary market by a stock exchange broker.
(c) in the secondary market by a securities dealer.
(d) in the secondary market by a commercial bank.

Answer: A
Question Status: Previous Edition

47) A corporation acquires new funds only when its securities are sold

(a) in the secondary market by an investment bank.
(b) in the primary market by an investment bank.
(c) in the secondary market by a stock exchange broker.
(d) in the secondary market by a commercial bank.

Answer: B
Question Status: Previous Edition

48) Which of the following assets is traded only in an over-the-counter market?

(a) treasury bonds
(b) stocks
(c) commodities
(d) all of the above
(e) none of the above

Answer: A
Question Status: Study Guide

49) Which of the following markets is sometimes organized as an over-the-counter market?

(a) The stock market
(b) The bond market
(c) The foreign exchange market
(d) The federal funds market
(e) Each of the above

Answer: E
Question Status: Previous Edition

50) Which of the following statements about financial markets and securities are true?

(a) Many common stocks are traded over-the-counter, although the largest corporations usually have their shares traded at organized stock exchanges such as the New York Stock Exchange.
(b) A corporation acquires new funds only when its securities are first sold in the primary market.
(c) Money market securities are usually more widely traded than longer-term securities and so tend to be more liquid.
(d) All of the above are true.
(e) Only (a) and (b) of the above are true.

Answer: D
Question Status: Previous Edition

51) Which of the following statements about financial markets and securities are true?

(a) Many common stocks are traded over-the-counter, although the largest corporations usually have their shares traded at organized stock exchanges such as the New York Stock Exchange.
(b) As a corporation gets a share of the broker's commission, a corporation acquires new funds whenever its securities are sold.
(c) Capital market securities are usually more widely traded than shorter-term securities and so tend to be more liquid.
(d) All of the above are true.

Answer: A
Question Status: Previous Edition

52) Which of the following statements about financial markets and securities are true?

(a) Few common stocks are traded over-the-counter, although the over-the-counter markets have grown in recent years.
(b) A corporation acquires new funds only when its securities are first sold in the primary market.
(c) Capital market securities are usually more widely traded than longer-term securities and so tend to be more liquid.
(d) All of the above are true.
(e) Only (a) and (b) of the above are true.

Answer: B
Question Status: Previous Edition

53) Which of the following statements about financial markets and securities are true?

(a) Many common stocks are traded over-the-counter, although the largest corporations usually have their shares traded at organized stock exchanges such as the New York Stock Exchange.
(b) As a corporation gets a share of the broker's commission, a corporation acquires new funds whenever its securities are sold.
(c) Because of their short terms to maturity, the prices of money market instruments tend not to fluctuate wildly.
(d) Only (a) and (b) of the above are true.
(e) Only (a) and (c) of the above are true.

Answer: E
Question Status: Previous Edition

54) 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
Question Status: Previous Edition

55) 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
Question Status: Previous Edition

56) The process of indirect finance using financial intermediaries is called
(a) direct lending.
(b) financial intermediation.
(c) disintermediation.
(d) financial liquidation.
(e) resource allocation.
Answer: B
Question Status: New

57) In the United States loans from _____ are far _____ important for corporate finance than are securities markets.
(a) government agencies; more
(b) government agencies; less
(c) financial intermediaries; more
(d) financial intermediaries; less
Answer: C
Question Status: Previous Edition

58) Financial intermediaries lower costs by spreading them over a large number of customers, thereby taking advantage of
(a) risk sharing.
(b) diversification.
(c) economies of scale.
(d) asymmetric information.
(e) transactions costs.
Answer: C
Question Status: New

59) Economies of scale enable financial institutions to
(a) reduce transactions costs.
(b) avoid the asymmetric information problem.
(c) eliminate the need to diversify.
(d) reduce moral hazard.
(e) avoid adverse selection problems.
Answer: A
Question Status: New

60) 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.
(e) all of the above.
Answer: D
Question Status: New

61) That depositors earn interest on checking and savings accounts, and yet withdraw their funds whenever necessary is possible because
(a) government regulations mandate this policy.
(b) financial intermediaries earn such large profits.
(c) financial intermediaries lower transaction costs.
(d) financial intermediaries hold highly diversified asset portfolios.
Answer: C
Question Status: Previous Edition

62) 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 shedding.
(e) risk selling.
Answer: A
Question Status: New

63) Risk sharing is also known as
(a) liability discounting.
(b) asset discounting.
(c) liability transformation.
(d) asset transformation.
(e) asset selection.
Answer: D
Question Status: New

64) Reducing risk through the purchase of assets whose returns do not always move together is
(a) disintermediation.
(b) intermediation.
(c) intervention.
(d) discounting.
(e) diversification.
Answer: E
Question Status: New

65) 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) the only thing we have to fear is fear itself.
(e) make hay while the sun shines.
Answer: B
Question Status: New

66) The process of asset transformation refers to the conversion of
(a) safer assets into risky assets.
(b) safer assets into risky liabilities.
(c) risky assets into safer assets.
(d) risky assets into risky liabilities.
(e) safer assets into safer liabilities.
Answer: C
Question Status: New

67) Risk sharing is profitable for financial institutions due to
(a) low transactions costs.
(b) asymmetric information.
(c) adverse selection.
(d) moral hazard.
(e) all of the above.
Answer: A
Question Status: New

68) The benefit of risk sharing to customers of financial institutions is
(a) reduced liquidity.
(b) reduced diversification.
(c) reduced liability.
(d) reduced risk.
(e) reduced return.
Answer: D
Question Status: New

69) The presence of transaction costs in financial markets explains, in part, why
(a) financial intermediaries and indirect finance play such an important role in financial markets.
(b) equity and bond financing play such an important role in financial markets.
(c) corporations get more funds through equity financing than they get from financial intermediaries.
(d) direct financing is more important than indirect financing as a source of funds.
Answer: A
Question Status: Previous Edition

70) Financial intermediaries
(a) exist because there are substantial information and transactions costs in the economy.
(b) improve the lot of the small saver.
(c) are involved in the process of indirect finance.
(d) do each of the above.
(e) do only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

71) Financial intermediaries promote economic efficiency and thereby increase people's wealth
(a) by reducing the transactions cost of linking together borrowers and lenders.
(b) to the extent that they help solve the problems due to asymmetric information.
(c) by reducing the exposure of investors to risk.
(d) because of all of the above.
(e) because of only (a) and (b) of the above.
Answer: D
Question Status: Study Guide

72) 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) adverse selection; moral hazard
(b) asymmetric information; risk sharing
(c) asymmetric information; adverse selection
(d) adverse selection; risk sharing
(e) moral hazard; adverse selection
Answer: C
Question Status: Study Guide

73) A potential borrower usually has better information about the potential returns and risk of the investment projects he plans to undertake than does the lender. This inequality of information is called
(a) moral hazard.
(b) asymmetric information.
(c) reverse causation.
(d) adverse selection.
Answer: B
Question Status: Previous Edition

74) 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
Question Status: Previous Edition

75) 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
Question Status: Previous Edition

76) The presence of _____ in financial markets leads to adverse selection and moral hazard problems that interfere with the efficient functioning of financial markets.
(a) noncollateralized risk
(b) free-riding
(c) asymmetric information
(d) costly state verification
Answer: C
Question Status: Previous Edition

77) 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% loss if the borrower defaults.
(c) the borrower's lack of incentive to seek a loan for highly risky investments.
(d) none of the above.
Answer: A
Question Status: Previous Edition

78) The concept of adverse selection helps to explain
(a) which firms are more likely to obtain funds from banks and other financial intermediaries, rather than from the securities markets.
(b) why indirect finance is more important than direct finance as a source of business finance.
(c) why direct finance is more important than indirect finance as a source of business finance.
(d) only (a) and (b) of the above.
(e) only (a) and (c) of the above.
Answer: D
Question Status: Previous Edition

79) That only large, well-established corporations have access to securities markets
(a) explains why indirect finance is such an important source of external funds for businesses.
(b) can be explained by the problem of adverse selection.
(c) can be explained by government regulations that prohibit small firms from acquiring funds in securities markets.
(d) can be explained by all of the above.
(e) can be explained by only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

80) In financial markets, lenders typically have inferior information about potential returns and risks associated with any investment project. This difference in information is called
(a) comparative informational disadvantage.
(b) asymmetric information.
(c) variant information.
(d) caveat venditor.
Answer: B
Question Status: Previous Edition

81) A professional baseball player may be contractually restricted from skiing. The team owner includes this clause in the player's contract to protect against
(a) fraud.
(b) moral hazard.
(c) adverse selection.
(d) regulatory circumvention.
(e) risk sharing.
Answer: B
Question Status: New

82) An example of the problem of ______ is when a corporation that uses the funds raised from selling new shares of stock 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
(e) prudential supervision
Answer: B
Question Status: New

83) A buyer of a used car faces the __________ problem that most of her choices are lemons.
(a) moral hazard
(b) adverse selection
(c) diversification
(d) free rider
(e) bureaucratic behavior
Answer: B
Question Status: New

84) In the early 1980s, a particular bank in Oklahoma developed a reputation of readily providing loans to borrowers for the purpose of exploring for oil deposits. Many of these loans were never repaid, because this bank failed to address the
(a) adverse selection problem.
(b) moral hazard problem.
(c) regulatory avoidance problem.
(d) risk-sharing problem.
(e) free-rider problem.
Answer: A
Question Status: New

85) American businesses get their external funds primarily from
(a) bank loans.
(b) bonds and commercial paper issues.
(c) stock issues.
(d) other loans.
Answer: A
Question Status: Previous Edition

86) Which of the following is the primary source of external funds used by American businesses to finance their activities?
(a) Stock
(b) Bonds and commercial paper
(c) Bank loans
(d) Other loans
Answer: C
Question Status: Previous Edition

87) Studies of the major developed countries show that
(a) external financing for corporations is dominated by financial intermediaries.
(b) external financing for corporations is dominated by securities issues.
(c) financial intermediaries avoid lending to corporations.
(d) none of the above are consistent across countries.
Answer: A
Question Status: Previous Edition

88) Not surprisingly, the United States and _____, which have the most developed securities markets in the world, also make the greatest use of them in financing corporations.
(a) Great Britain
(b) Canada
(c) Japan
(d) Germany
Answer: B
Question Status: Previous Edition

89) 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
Question Status: Previous Edition

90) The countries that have made the least use of securities markets are Germany and Japan; in these two countries finance from financial intermediaries has been almost _____ times greater than that from securities markets.

(a) three
(b) four
(c) five
(d) ten

Answer: D
Question Status: Previous Edition

91) 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
Question Status: Previous Edition

92) 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
Question Status: Previous Edition

93) 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
(e) None of the above

Answer: D
Question Status: Previous Edition

94) 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
Question Status: Previous Edition

95) Contractual savings institutions include
(a) mutual savings banks.
(b) money market mutual funds.
(c) commercial banks.
(d) life insurance companies.
(e) all of the above.

Answer: D
Question Status: Study Guide

96) Which of the following are not contractual savings institutions?
(a) Life insurance companies
(b) Credit unions
(c) Pension funds
(d) State and local government retirement funds

Answer: B
Question Status: Previous Edition

97) Which of the following financial intermediaries are not depository institutions?
(a) Finance companies
(b) Pension funds
(c) Savings and loan associations
(d) Only (a) and (b) of the above
(e) Only (b) and (c) of the above

Answer: D
Question Status: Previous Edition

98) Which of the following are not contractual savings institutions?
(a) A life insurance company
(b) A pension fund
(c) A mutual fund
(d) Only (a) and (b) of the above

Answer: C
Question Status: Previous Edition

99) Which of the following are investment intermediaries?
(a) Life insurance companies
(b) Mutual funds
(c) Pension funds
(d) State and local government retirement funds

Answer: B
Question Status: Previous Edition

100) Which of the following financial intermediaries are depository institutions?
(a) A savings and loan association
(b) A commercial bank
(c) A money market mutual fund
(d) All of the above
(e) Only (a) and (b) of the above

Answer: E
Question Status: Previous Edition

101) 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
Question Status: Previous Edition

102) Which of the following are depository institutions?
(a) Mutual savings banks
(b) Credit unions
(c) Mutual funds
(d) All of the above
(e) Only (a) and (b) of the above

Answer: E
Question Status: Previous Edition

103) Which of the following is a depository institution?
(a) A life insurance company
(b) A mutual savings bank
(c) A pension fund
(d) A finance company
(e) The stock exchange

Answer: B
Question Status: Study Guide

104) Which of the following is not a contractual savings institution?
(a) A life insurance company
(b) A pension fund
(c) A savings and loan association
(d) A fire and casualty insurance company

Answer: C
Question Status: Previous Edition

105) Which of the following are not investment intermediaries?
(a) A life insurance company
(b) A pension fund
(c) A mutual fund
(d) Only (a) and (b) of the above

Answer: D
Question Status: Previous Edition

106) Which of the following are investment intermediaries?
(a) Finance companies
(b) Mutual funds
(c) Pension funds
(d) All of the above
(e) Only (a) and (b) of the above

Answer: E
Question Status: Previous Edition

107) The primary assets of a mutual savings bank are
(a) bonds.
(b) mortgages.
(c) stocks.
(d) deposits.
(e) commercial loans.

Answer: B
Question Status: Study Guide

108) The primary liabilities of a credit union are
(a) bonds.
(b) mortgages.
(c) stocks.
(d) commercial loans.
(e) deposits.

Answer: E
Question Status: Study Guide

109) 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
Question Status: Previous Edition

110) The primary assets of a savings and loan association are
(a) money market instruments.
(b) corporate bonds and stock.
(c) consumer and business loans.
(d) mortgages.
Answer: D
Question Status: Previous Edition

111) The primary assets of credit unions are
(a) municipal bonds.
(b) business loans.
(c) consumer loans.
(d) mortgages.
Answer: C
Question Status: Previous Edition

112) 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
Question Status: Previous Edition

113) The primary assets of commercial banks include
(a) mortgages.
(b) consumer and business loans.
(c) U.S. government securities.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

114) The primary assets of fire and casualty insurance companies include

(a) municipal bonds.
(b) corporate stocks and bonds.
(c) consumer and business loans.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: E
Question Status: Previous Edition

115) The primary source of funds of fire and casualty insurance companies include

(a) commercial paper, stocks, and bonds.
(b) premiums from policies.
(c) savings deposits.
(d) all of the above.

Answer: B
Question Status: Revised

116) The primary liabilities of a commercial bank are

(a) bonds.
(b) mortgages.
(c) deposits.
(d) commercial paper.

Answer: C
Question Status: Previous Edition

117) The primary liabilities of depository institutions are

(a) premiums from policies.
(b) shares.
(c) stocks.
(d) bonds.
(e) deposits.

Answer: E
Question Status: New

118) The primary assets of money market mutual funds are

(a) stocks.
(b) bonds.
(c) money market instruments.
(d) municipal bonds.
(e) deposits.

Answer: C
Question Status: New

119) Money market mutual fund shares function like
(a) checking accounts that pay interest.
(b) bonds.
(c) stocks.
(d) currency.
(e) municipal bonds.
Answer: A
Question Status: New

120) An important feature of money market mutual fund shares is
(a) deposit insurance.
(b) the ability to write checks against shareholdings.
(c) the ability to borrow against shareholdings.
(d) claims on shares of corporate stock.
(e) all of the above.
Answer: B
Question Status: New

121) Thrift institutions include
(a) banks, mutual funds, and insurance companies.
(b) life insurance companies, fire and casualty companies, and pension funds.
(c) finance companies, mutual funds, and money market funds.
(d) pension funds, mutual funds, and banks.
(e) savings and loan associations, mutual savings banks, and credit unions.
Answer: E
Question Status: New

122) 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
Question Status: Previous Edition

123) The Federal Deposit Insurance Corporation (FDIC) regulates
(a) savings and loan associations.
(b) mutual savings banks.
(c) credit unions.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

124) Savings and loan associations are regulated by the
(a) Federal Reserve System.
(b) Securities and Exchange Commission.
(c) Office of the Comptroller of the Currency.
(d) Office of Thrift Supervision.
(e) Department of Justice.

Answer: D
Question Status: Study Guide

125) Which of the following regulates at least some commercial banks?
(a) The Office of the Comptroller of the Currency
(b) The Federal Deposit Insurance Corporation (FDIC)
(c) The Federal Reserve System
(d) Each of the above
(e) Only (a) and (b) of the above

Answer: D
Question Status: Previous Edition

126) Which of the following examines the books of depository institutions?
(a) The Office of the Comptroller of the Currency
(b) The Federal Reserve System
(c) The National Credit Union Administration
(d) State banking and insurance commissions
(e) Each of the above

Answer: E
Question Status: Previous Edition

127) Which of the following do not provide charters?
(a) The Office of the Comptroller of the Currency
(b) The Federal Reserve System
(c) The National Credit Union Administration
(d) State banking and insurance commissions

Answer: B
Question Status: Previous Edition

128) Regulations that protect against financial panics include
(a) restrictions on entry.
(b) disclosure.
(c) deposit insurance.
(d) restrictions on assets and activities.
(e) all of the above.

Answer: E
Question Status: New

129) The agency that was created to protect depositors after the banking panics of 1930–1933 is the
(a) Federal Reserve System.
(b) Federal Deposit Insurance Corporation.
(c) Treasury Department.
(d) Office of the Comptroller of the Currency.
(e) all of the above.

Answer: B
Question Status: New

130) An important restriction on bank activities that was repealed in 1999 was
(a) the prohibition of the payment of interest on checking deposits.
(b) restrictions on credit terms.
(c) minimum down payments on loans to purchase securities.
(d) separation of commercial banking from the securities industries.
(e) prohibition on ownership of municipal bonds.

Answer: D
Question Status: New

131) A goal of the Securities and Exchange Commission is to reduce problems arising from
(a) competition.
(b) banking panics.
(c) risk.
(d) asymmetric information.
(e) all of the above.

Answer: D
Question Status: New

132) Asymmetric information is a universal problem. This would suggest that
(a) financial regulation exists only in the United States.
(b) financial regulations differ significantly around the world.
(c) financial regulations in industrialized nations are similar.
(d) financial regulations are unnecessary.
(e) financial regulations in industrial countries are an unqualified failure.

Answer: C
Question Status: New

133) The purpose of the disclosure requirements of the Securities and Exchange Commission is to
(a) increase the information available to investors.
(b) prevent bank panics.
(c) improve monetary control.
(d) protect investors against financial losses.
(e) all of the above.

Answer: A
Question Status: New

134) 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.
(e) all of the above.
Answer: B
Question Status: New

135) In order to reduce risk and increase the safety of financial institution, commercial banks and other financial institutions are prohibited from
(a) owning municipal bonds.
(b) making real estate loans.
(c) making personal loans.
(d) owning common stock.
(e) all of the above.
Answer: D
Question Status: New

Questions for Web Appendix to Chapter 2

136) U.S. Treasury bills
(a) are the safest of all money market instruments.
(b) sell at a discount because they have no interest payments.
(c) are the most liquid of the money market securities.
(d) are all of the above.
(e) are only (b) and (c) of the above.
Answer: D
Question Status: Previous Edition

137) U.S. Treasury bills are issued in
(a) three-, six-, nine-, and twelve-month maturities.
(b) three-, nine-, and twelve-month maturities.
(c) three-, six-, and twelve-month maturities.
(d) three-, and six-month maturities.
Answer: C
Question Status: Previous Edition

138) U.S. Treasury bills
(a) are issued in three-, six-, nine-, and twelve-month maturities.
(b) sell at a discount because they have no interest payments.
(c) are the most liquid of the money market securities.
(d) are all of the above.
(e) are only (b) and (c) of the above.
Answer: E
Question Status: Previous Edition

139) U.S. Treasury bills

(a) are issued in three-, six-, and twelve-month maturities.
(b) sell at a discount because they have no interest payments.
(c) are the most liquid of the money market securities.
(d) are all of the above.
(e) are only (b) and (c) of the above.

Answer: D
Question Status: Previous Edition

140) 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 banker' acceptance.
(d) federal funds.

Answer: B
Question Status: Previous Edition

141) Federal funds are

(a) funds raised by the federal government in the bond market.
(b) loans made by the Federal Reserve System to banks.
(c) loans made by banks to the Federal Reserve System.
(d) loans made by banks to each other.
(e) none of the above.

Answer: D
Question Status: Previous Edition

142) Which of the following are short-term financial instruments?

(a) A negotiable certificate of deposit
(b) A bankers acceptance
(c) A six-month loan
(d) A U.S. Treasury bill
(e) All of the above

Answer: E
Question Status: Previous Edition

143) Which of the following are short-term financial instruments?

(a) A negotiable certificate of deposit
(b) A bankers acceptance
(c) A U.S. Treasury bond
(d) Both (a) and (b) of the above
(e) Both (b) and (c) of the above

Answer: D
Question Status: Previous Edition

144) Which of the following are short-term financial instruments?
(a) A banker's acceptance
(b) A share of Walt Disney Corporation stock
(c) A Treasury note with a maturity of four years
(d) Each of the above

Answer: A
Question Status: Previous Edition

145) Which of the following instruments are traded in a money market?
(a) State and local government bonds
(b) U.S. Treasury bills
(c) Corporate bonds
(d) All of the above

Answer: B
Question Status: Previous Edition

146) Which of the following instruments are traded in a money market?
(a) Bank commercial loans
(b) Banker's acceptances
(c) State and local government bonds
(d) Residential mortgages.

Answer: B
Question Status: Previous Edition

147) Which of the following instruments is not traded in a money market?
(a) Banker's acceptances
(b) U.S. Treasury Bills
(c) Eurodollars
(d) Commercial paper
(e) None of the above

Answer: E
Question Status: Previous Edition

148) Which of the following instruments is not traded in a money market?
(a) Banker's acceptances
(b) U.S. Treasury Bills
(c) Eurodollars
(d) Commercial paper
(e) Residential mortgages

Answer: E
Question Status: Previous Edition

149) Which of the following are long-term financial instruments?
(a) A negotiable certificate of deposit
(b) A bankers acceptance
(c) A six-month loan
(d) A U.S. Treasury bill
(e) None of the above

Answer: E
Question Status: Previous Edition

150) Which of the following are long-term financial instruments?
(a) A negotiable certificate of deposit
(b) A banker's acceptance
(c) A U.S. Treasury bond
(d) A U.S. Treasury bill

Answer: C
Question Status: Previous Edition

151) Which of the following instruments are traded in a capital market?
(a) U.S. Government agency securities
(b) Negotiable bank CDs
(c) Repurchase agreements
(d) Banker's acceptances
(e) None of the above

Answer: A
Question Status: Previous Edition

152) Which of the following instruments are traded in a capital market?
(a) U.S. Government agency securities
(b) State and local government bonds
(c) Repurchase agreements
(d) All of the above
(e) Both (a) and (b) of the above

Answer: E
Question Status: Previous Edition

153) Which of the following instruments are traded in a capital market?
(a) Corporate bonds
(b) U.S. Treasury bills
(c) Banker's acceptances
(d) Repurchase agreements

Answer: A
Question Status: Previous Edition

■ Essay Questions

1) Explain the difference between direct and indirect finance. What role do financial intermediaries and financial markets play in this process? Explain whether direct or indirect finance is a more important source of finds and why this is the case.

Answer: Students should explain that direct finance involves transfer of funds directly from borrowers to lenders, while for indirect finance, funds are channeled from borrowers to lenders through intermediaries.
Direct finance occurs in financial markets, while indirect finance involves financial intermediaries.
Indirect finance is more important, because transactions costs and asymmetric information make direct finance costly in many cases.

2) Explain the concepts of asymmetric information, adverse selection, and moral hazard. When do adverse selection and moral hazard become relevant to the lending process? How has the financial system developed to deal with these problems?

Answer: Asymmetric information is uneven information, which creates the problems of adverse selection and moral hazard. Adverse selection is having a disproportionate number of high-risk loan applications. Moral hazard is the risk that the borrower will engage in risky behavior after the loan is made. Adverse selection is a problem before a loan is made, and moral hazard is a problem that exists after a loan is made. Financial intermediaries develop the expertise to screen and monitor loans, overcoming these problems. Regulations require timely provision of information.

3) Why does the government regulate the financial system? 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. The SEC requires timely provision of information. 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.