MASINDE MULIRO UNIVERSITY OF SCIENCE AND TECHNOLOGY

At the Vision Institute of Professionals, Nairobi.

FINANCIAL INSTITUTIONS AND MARKETS CAT 1(17 July, 2012) TIME: 1 hr 30 mins

ATTEMPT ALL QUESTIONS

PART A (10 mks)

1) Financial markets promote economic efficiency by
- A) Channelling funds from investors to savers.
- B) Creating inflation.
- C) Channelling funds from savers to investors.
- D) Reducing investment.

2) The bond markets are important because they are
- A) Easily the most widely followed financial markets in Kenya.
- B) The markets where foreign exchange rates are determined.
- C) The markets where interest rates are determined.
- D) The markets where all borrowers get their funds.

3) Compared to interest rates on long-term government bonds (treasury bonds), interest rates on three-month (91 day) Treasury bills fluctuate ________ and are ________ on average.
- A) More; lower
- B) Less; lower
- C) More; higher
- D) Less; higher

4) A share of common stock is a claim on a corporation's
- A) Debt.
- B) Liabilities.
- C) Expenses.
- D) Earnings and assets.

5) Stock prices are
- A) Relatively stable trending upward at a steady pace.
- B) Relatively stable trending downward at a moderate rate.
- C) Extremely volatile.
- D) Unstable trending downward at a moderate rate.

6) Financial institutions that accept deposits and make loans are called ________.
- A) Exchanges
- B) Banks
- C) Over-the-counter markets
- D) Finance companies

7) 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.

8) 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.

9) Which of the following can be described as direct finance?

A) You take out a mortgage from your local bank.

B) You borrow Ksh. 2500 from a friend.

C) You buy shares of common stock in the secondary market.

D) You buy unit trusts in a mutual fund.

10) Which of the following statements about the characteristics of debt/ bonds 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.

PART B (35 mks) (BE CONCISE IN PRESENTING ANSWERS)

1. As a financial manager of a large firm, you plan to raise Ksh. 70 million over the next 6 months. List down and **BRIEFLY** explain three sources of such funds in each of;
    a. The money market (6 mks)
    b. The capital Market (6 mks)
2. When and why would you prefer to raise cash in the money market as opposed to the capital markets? (4 mks).
3. List and **BRIEFLY** discuss briefly the various participants in financial markets, using a diagram where possible (6 mks).
4. Distinguish between deposit-taking and non-deposit-taking financial institutions, giving two examples of each. (8 mks)
5. Distinguish between moral hazard and adverse selection and give a real world example of each in the context of financial institutions/ markets. (5 mks)

PART C (15 mks) (BE CONCISE IN PRESENTING ANSWERS)

Moody's cuts Italy's debt rating

Moody's has cut Italy's credit rating, warning that the country was likely to see a sharp rise in borrowing costs. The rating was cut two notches from A3 to Baa2, <u>two levels above junk</u> status. The move raised concerns of a contagion risk from Spain and Greece, pushed Italian bank shares down and kept the euro near two-year lows against the dollar. Moody's said that Italy's near-term economic outlook had "deteriorated" and access to credit markets could toughen. On Thursday, Italy had raised 7.5bn Euros (£6bn) in one-year bonds at a much lower rate than previously, suggesting improved investor confidence. On Friday, after Moody's downgrade, Italy raised 3.5bn Euros in an auction of medium-term government bonds, with the rate falling to 4.65% from 5.3% last month. Moody's said in its statement that Italy was now "more likely to experience a further sharp increase in its funding costs or the loss of market access" for borrowing to service its budget. (**SOURCE**: *The BBC. Retrieved on 15th July 2012, from http://www.bbc.co.uk/news/business-18824246).*

Questions

1. In your opinion, what would drive a credit rating agency such as Moody's to lower the credit rating of a country or organization. (2 mks)
2. Cite the implications of the cutting of the credit rating for Italy. (4 mks).
3. Explain term JUNK (as used in the underlined phrase in the passage) (5 mks)
4. Highlight the role played by credit reference bureaus in the economy. (4 mks).
5. Distinguish between direct finance and indirect finance. Which of these is the most important source of funds for corporations in Kenya? (5 mks)