# **LAIKIPIA UNIVERSITY COLLEGE**

# **Nyahururu Campus**

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

**ATTEMPT ALL QUESTIONS**

**PART A (25 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.**

**11) Depositors lack of information about the quality of bank assets can lead to \_\_\_\_\_\_\_\_.**

**A) Bank panics**

**B) Bank booms**

**C) Sequencing**

**D) Asset transformation**

**12) Because of asymmetric information, the failure of one bank can lead to runs on other banks. This is the**

**A) Too-big-to-fail effect.**

**B) Moral hazard problem.**

**C) Adverse selection problem.**

**D) Contagion effect.**

**13) Deposit insurance is only one type of government safety net. All of the following are types of government support for troubled financial institutions except**

**A) Forgiving tax debt.**

**B) Lending from the central bank.**

**C) Lending directly from the government’s treasury department.**

**D) Nationalizing and guaranteeing that all creditors will be repaid their loans in full.**

**14) Although the Deposit Protection Fund was created to prevent bank failures, it encourages banks to**

**A) Take too much risk.**

**B) Hold too much capital.**

**C) Open too many branches.**

**D) Buy too much stock.**

**15) The too-big-to-fail policy**

**A) Reduces moral hazard problems.**

**B) Puts large banks at a competitive disadvantage in attracting large deposits.**

**C) Treats large depositors of small banks inequitably when compared to depositors of large banks.**

**D) Allows small banks to take on more risk than large banks.**

**16) Regulators attempt to reduce the riskiness of banksʹ asset portfolios by**

**A) Limiting the amount of loans in particular categories or to individual borrowers.**

**B) Encouraging banks to hold risky assets such as common stocks.**

**C) Establishing a minimum interest rate floor that banks can earn on certain assets.**

**D) Requiring collateral for all loans.**

**17) A well-capitalized financial institution has \_\_\_\_\_\_\_\_ to lose if it fails and thus is \_\_\_\_\_\_\_\_ likely to pursue risky activities.**

**A) More; more**

**B) More; less**

**C) Less; more**

**D) Less; less**

**18) Although foreign exchange market trades are said to involve the buying and selling of currencies, most trades involve the buying and selling of**

**A) Bank deposits denominated in different currencies.**

**B) SDRs.**

**C) Gold.**

**D) Dollars.**

**19) The immediate (two-day) exchange of one currency for another is a**

**A) Forward transaction.**

**B) Spot transaction.**

**C) Money transaction.**

**D) Exchange transaction.**

**20) An agreement to exchange dollar bank deposits for euro bank deposits in one month is a**

**A) Spot transaction.**

**B) Future transaction.**

**C) Forward transaction.**

**D) Deposit transaction.**

**21) If the U.S. dollar appreciates from 1.25 Swiss franc per U.S. dollar to 1.5 francs per dollar, then the franc depreciates from \_\_\_\_\_\_\_\_ U.S. dollars per franc to \_\_\_\_\_\_\_\_ U.S. dollars per franc.**

**A) 0.80; 0.67**

**B) 0.67; 0.80**

**C) 0.50; 0.33**

**D) 0.33; 0.50**

**22) The starting point for understanding how exchange rates are determined is a simple idea called**

**\_\_\_\_\_\_\_\_, which states: if two countries produce an identical good, the price of the good should**

**be the same throughout the world no matter which country produces it.**

**A) Gresham’s law**

**B) The law of one price**

**C) Purchasing power parity**

**D) Arbitrage**

**23) The \_\_\_\_\_\_\_\_ states that exchange rates between any two currencies will adjust to reflect changes in the price levels of the two countries.**

**A) Theory of purchasing power parity**

**B) Law of one price**

**C) Theory of money neutrality**

**D) Quantity theory of money**

**24) The theory of PPP suggests that if one country’s price level rises relative to another’s, its currency should**

**A) Depreciate.**

**B) Appreciate.**

**C) Float.**

**D) Do none of the above.**

**25) In the one-period valuation model, the value of a share of stock today depends upon**

**A) The present value of both dividends and the expected sales price.**

**B) Only the present value of the future dividends.**

**C) The actual value of the dividends and expected sales price received in one year.**

**D) The future value of dividends and the actual sales price.**

**PART B (40 mks) (BE CONCISE IN PRESENTING ANSWERS)**

1. **Distinguish between moral hazard and adverse selection and give a real world example of each in the context of financial institutions/ markets. (5 mks).**
2. **What is the difference between money market instruments quoted ‘on a discount basis’ and ‘on a yield basis’? Suppose that one-month treasury bills and one-month CDs are both quoted as having a rate of return of 5 per cent. Which gives the higher return to an investor? (5 mks)**
3. **You aim to reduce the capital risk of your portfolio by increasing your holdings of government bonds. Given a choice between ‘5% Treasury bills maturing in 2020’ and ‘12% treasury bonds maturing 2014’, which would you choose and why? (5 mks)**
4. **Explain the terms: dirty price, clean price, accrued interest, interest yield, redemption yield. (10 mks)**
5. Examine the following set of exchange rates for three currencies denoted as $, £, and A:

£1 = A1.458;

$1 = A0.753;

£1 = $1.886

What is wrong with these rates? If these rates did apply, how would it be possible to make a profit by trading in these currencies? Would this be arbitrage or speculation? (9 mks)

1. Why is it more risky to write (sell) options contracts than to buy them? (6 mks)

**PART C (30 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;**
   1. **The money market (6 mks)**
   2. **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)**

**PART D (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, two levels above junk 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](http://www.moodys.com/research/Moodys-downgrades-Italys-government-bond-rating-to-Baa2-from-A3--PR_250567) "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)