ANSWERS TO THE

QUESTIONS IN THE

COURSE GUIDE

CPCU 560

7th Edition

2015-2016

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Assignment 1

Introduction to Financial Markets and Institutions

Educational Objectives

1. Financial markets bring suppliers of funds and users of funds together. Suppliers of funds will seek a positive return in exchange for the use of their funds. Primary markets allow fund users to raise money through new securities issues. Secondary markets provide diversity and liquidity by allowing the selling and buying of previously issued securities.

2. Financial institutions serve as middlemen between fund suppliers and fund users. Fund suppliers and fund users frequently find that financial institutions provide the most cost-effective way to channel funds to each other. Financial institutions provide monitoring and asset transformation services that, in turn, reduce costs, provide liquidity, and reduce risks for the investor.

3. **Interest rate risk** – The risk that the maturities of assets and liabilities are mismatched, thus making the financial institution vulnerable to a change in interest rates. For example, a bank offers 30-year mortgages at a fixed rate of 6.5%, funded by short-term interest-bearing checking accounts paying 3%. If short-term interest rates rise to 8%, the bank would lose money.

Foreign exchange risk – The risk that the value of the currency in the country in which the investment is held will fluctuate, thus causing the value of the investment to fluctuate in an adverse way. For example, if the exchange rate for the dollar falls, a U.S. investor will receive less dollars for each unit of the foreign currency earned through investment.

Market risk – The risk that if a market declines in value, all or most of the securities in the market will decline in value, too.

Credit risk – The risk that an obligation will not be paid, resulting in a loss to the financial institution.

Key Words and Phrases

1. Financial markets are the structures that facilitate the flow of funds between fund suppliers and fund users. Those with excess funds (fund suppliers) will offer the use of their funds to those in need of funds (fund users). The fund suppliers will expect to receive a rate of return on their investment.

2. Primary markets are the markets where corporations sell new issues of securities, usually with the help of investment bankers.

3. Initial public offerings (IPOs) are first-time issues of equity by firms allowing their shares to be publicly traded on stock markets for the first time.

4. A derivative security is a financial instrument whose value is linked to the performance of an underlying security. Options are an example of a derivative security.

5. Securities that have already been issued are traded in the secondary markets. Economic agents (consumers, corporations, governments) with excess funds buy secondary market securities. Economic agents in need of funds sell secondary market securities.

6. Money markets are markets where investors can trade debt securities or other instruments that will mature within one year.

7. Money market instruments are securities with maturities of one year or less or long-term debt with one year of maturity remaining. Examples of money market instruments are commercial paper, repurchase agreements, negotiable CDs, and Treasury bills.

Review Questions

1. Boundaries among financial institutions have been weakened in the following two respects:

(1) Boundaries between traditional industry sectors, such as banking, insurance, and stock investing, are weakening because financial institutions are offering a full set of financial services under one roof.

(2) Global boundaries are weakening because the U.S. is entering foreign financial services markets, and vice versa.

2. Primary markets are the markets for new issues of corporate securities. The proceeds of the sale go to the issuer of the securities.

3. The role that investment banks play a role in the primary markets is arranging primary market transactions by serving as intermediaries between the issuer and the investor. For example, in a firm commitment underwriting, the underwriter assures the issuer of a fixed cash inflow by buying the whole issue and trying to sell it to investors at a profit.

4. Secondary markets provide benefits to investors and the original issuing corporation by facilitating original financing for corporations and providing liquidity and diversity to investors. The liquidity provided by the secondary market allows holders of the issued securities to sell them and receive cash and reinvest in other issues. For example, Investor A buys a new issue of Company XYZ. The investor turns around and sells it to Investor B in the secondary market. Investor A can now take the proceeds from that sale and buy more new issues or buy more secondary market securities. Secondary markets also tell corporate issuers how investors perceive the value of their companies by tracking securities prices. This lets them know how much money they can expect to raise in future offerings.

Application Questions

1. (a) The capital market is much larger than the money market. The number of securities issued and their market prices determine the size of the capital market. The bull market of the 1990s pushed up stock prices considerably.

(b) The first, second, and third largest capital markets in 2007 were:

1st – Corporate stocks
2nd – Residential mortgages
3rd – Corporate bonds

2. Investment companies seemed to take business away from thrift institutions (savings and loans and credit unions).

PRACTICE EXAMINATION

and

TRIAL TESTS

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Financial Services Institutions

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Introduction to Financial Markets and Institutions

Practice Exam Questions

Part A

1. Explain the difference between primary and secondary markets.

2. Explain the difference between money markets and capital markets. What types of financial instruments are traded on each? Which market is considered more volatile?

3. Explain what might happen in the economy if there were no financial institutions.

Part B

1. Janet Wood, a U.S. Citizen, is considering making a $50,000 investment in the bonds of a Mexican corporation. The bonds are denominated in pesos. If the peso decline in value against the dollar after Janet buys the bonds, what will happen to Janet's investment? What other risks does Janet bear with this investment? If Janet's bank decides to buy the bonds, how could it better withstand the risks?

2. AMK, a company that went public in 1999, announced the sale of an additional 50 million shares of its common stock on June 1, 2002. Before deciding on the additional stock, AMK analyzed how its stocks and bonds were trading in the secondary markets. Why did AMK study the secondary markets if the additional shares of common stock were considered new issues, thus being sold in the primary markets?

Assignment 1

Introduction to Financial Markets and Institutions

Practice Exam Answers

Part A

1. Primary markets raise funds through new issues of financial instruments. The funds from the sale of the new issues go to the fund user. An investment bank will normally buy the issue from the fund user and sell it to the fund suppliers at a higher price. Secondary markets occur when buyers and sellers trade already issued securities. A securities brokerage firm will act as the intermediary. Secondary markets serve the primary market by offering diversity and liquidity to holders of new issues, thus encouraging investment in more new issues. Secondary markets also help corporations track how well investors perceive their company is doing.

2. Money markets trade short-term debt instruments such as banker's acceptances, commercial paper, and negotiable certificates of deposit. Due to the short-term nature of money market instruments, they are considered safe and liquid. In the U.S., the money markets trade over-the counter (not on a specific exchange). The capital markets trade equity and long-term (over one-year maturity) debt. Examples of capital market securities are common and preferred stock and corporate bonds. Since risk tends to be higher for long-term investments due to uncertainty about future actions that could affect the investment's value, the capital market is considered more volatile than the money market.

3. Users of funds would have a harder time obtaining funds from suppliers of funds. Monitoring costs would discourage potential investors from supplying funds for investment. Or, in some cases, investors might try to avoid monitoring costs by just not monitoring their fund borrowers sufficiently (increasing their default risk). Fund suppliers would also want to hold on to their cash instead of tying up

their funds in long-term commitments. Fund suppliers would also hesitate to invest due to the fact that they would have to bear the full risk that an asset's sale price would be less than its purchase price.

Part B

1. If the peso declines over the maturity of the bonds, the dollar value of the cash flows from the bonds will fall, as well as the dollar value of the bonds' principal. Janet also faces "country, or sovereign," risk (although it may not be a large one), the risk that the Mexican government will interfere with her repayments through a change in national policy. Another risk Janet bears is the risk that interest rates will rise, and the value of her fixed rate bonds will fall.

The bank's ability to diversify its portfolio reduces the risks associated with buying these bonds. The bank could hedge the currency risk by buying bonds denominated in other currencies. It could reduce its exposure to the country, or sovereign, risk by obtaining securities in countries where that risk is extremely small (i.e., the U.S.). It could reduce the interest rate risk by matching the maturities of other assets to the bonds.

2. In the secondary markets, the transfer of funds flows between the holder of the financial instrument and the buyer; there is no flow of funds to the issuer. AMK studied the secondary markets to track the trading of its existing financial instruments to obtain information about their current market value. This told AMK if it was effectively using the funds it had already raised. It also gave AMK an idea of how much money it could raise and at what cost with another offering. The goal of AMK was to obtain the required amount of funds needed at the lowest cost.