# Chapter 1: Overview of the financial system

**TRUE/FALSE**

1. Australia went through a process of increasing regulations on the financial system in the 1980s.

ANS: F

Deregulation in the 1980s removed many regulations on banks and financial markets and contributed to greater efficiency in the flow of funds.

PTS: 1 DIF: Easy REF: *Introduction*

2. A financial crisis can be triggered when people lose ‘trust’ or confidence that their financial dealings will be honoured.

ANS: T

This makes people reluctant to supply funds.

PTS: 1 DIF: Moderate REF: *Introduction*

3. According to Merton (1995), financial systems perform three functions. These are the settlement function, the flow of funds function and the risk-transfer function.

ANS: F

Merton also includes overcoming information asymmetry, resolving incentive problems and promoting the pooling of funds as functions of the financial system.

PTS: 1 DIF: Easy REF: *1.1 Financial functions*

4. Transactions are settled by the exchange of money from the buyer to the seller.

ANS: T

Money includes cash and a variety of electronic payment methods.

PTS: 1 DIF: Moderate REF: *1.1.1 The settlement function*

5. The term ‘flow of funds’ refers to the exchange of value required to settle commercial transactions.

ANS: F

The flow of funds is the allocation of finance from surplus to deficit units.

PTS: 1 DIF: Moderate REF: *1.1.2 The flow of funds function*

6. The flow of funds is arranged directly when funds are deposited with banks, and indirectly when funds are invested in securities.

ANS: F

The flow of funds through banks is referred to as indirect financing since the funds are lent to banks, which in turn lend to deficit units. Direct financing occurs when funds are supplied directly to deficit units through the sale of securities.

PTS: 1 DIF: Easy REF: *1.1.2 The flow of funds function*

7. Securities are financial contracts that are used by deficit units to raise funds and by surplus units for investment.

ANS: T

The security will specify the types of payments the deficit unit will make to the supplier of funds.

PTS: 1 DIF: Easy REF: *1.1.2 The flow of funds function*

8. Derivative contracts can be used to both increase and decrease exposure to risk.

ANS: T

We concentrate on their use in risk-reduction (‘hedging’) but derivatives can also be used for investment/speculative purposes.

PTS: 1 DIF: Moderate REF: *1.1.3 The risk-transfer function*

9. The risk that the value of bonds falls because of an unexpected increase in interest rates is known as default risk.

ANS: F

The chance of loss as a result of an unexpected change in a market variable (an interest rate, exchange rate or the value of market traded asset) is market risk. Default risk is the chance of loss resulting from a financial obligation not being met.

PTS: 1 DIF: Moderate REF: *1.1.3 The risk-transfer function*

10. Information asymmetry arises where a contract distorts incentives to behave appropriately.

ANS: F

Information asymmetry arises where one party to a potential contract is better informed than the other party.

PTS: 1 DIF: Moderate REF: *1.1.4 Overcoming information asymmetry*

11. Moral hazard problems arise in the financial system because people are fundamentally dishonest.

ANS: F

Moral hazard refers to arrangements that create an incentive for one party to a transaction to act in his or her own interests at the expense of the other party to whom they may owe a duty of care.

PTS: 1 DIF: Difficult REF: *1.1.5 Overcoming incentive problems*

12. The pooling of funds is required because surplus units typically prefer short-term contracts for small amounts whereas deficit units commonly require large amounts for long periods.

ANS: T

Pooling is performed by banks when they accept many small deposits that are used to fund a smaller number of much larger loans, and by the financial markets when securities are sold to many investors in order to raise a large sum.

PTS: 1 DIF: Easy REF: *1.1.6 Pooling of funds*

13. Firms and the government are the largest sources of finance in the Australian financial system.

ANS: F

Savings by households are the largest source of finance. These funds are supplied as bank deposits and as investments in financial assets (mostly through superannuation schemes).

PTS: 1 DIF: Difficult REF: *1.2 An introduction to finance*

14. The returns earned from supplying funds include interest, dividends and the potential for capital gains.

ANS: T

These returns can be low risk and return (such as the interest on bank deposits) or have higher risk and return (such as the dividends and capital gains on shares).

PTS: 1 DIF: Moderate REF: *1.2 An introduction to finance*

15. Risk-averse investors will always choose low risk and return investments.

ANS: F

Risk-averse investors require a higher return to compensate them for taking on higher risks.

PTS: 1 DIF: Difficult REF: *1.2 An introduction to finance*

16. The size of risk premiums will change over time.

ANS: T

Risk premiums reflect the attitude of investors to risk. For example, when lenders are very confident (in regards to the economy and the ability of borrowers to make repayments), they will charge lower risk premiums.

PTS: 1 DIF: Difficult REF: *1.2 An introduction to finance*

17. The risk associated with an unsecured loan is greater than the risk associated with an otherwise identical secured loan.

ANS: T

The lender in a secured loan arrangement has greater protection than the lender in an unsecured loan arrangement.

PTS: 1 DIF: Easy REF: *1.2.1(a) Debt finance*

18. Debt is often referred to as ‘risk capital’ because debt holders only have a residual claim on the firm’s earnings.

ANS: F

Equity is known as risk capital because returns to suppliers of equity are achieved only after the firm’s other commitments (including those to debt holders) have been met.

PTS: 1 DIF: Moderate REF: *1.2.1(b) Equity*

19. Equity is considered riskier than debt because the returns to its suppliers are non-enforceable.

ANS: T

Dividends are paid at the discretion of the company whereas interest and principal repayments on debt are a legal obligation of the company.

PTS: 1 DIF: Difficult REF: *1.2.1(c) Debt versus equity*

20. Leveraged investments always produce better returns than unlevered investments.

ANS: F

Leverage (debt financing) increases the risk of an investment – both potential profits and losses are increased.

PTS: 1 DIF: Moderate REF: *1.2.1(c) Debt versus equity*

21. A firm does not have to repay its equity funds and is not obliged to pay dividends. Therefore equity is a cheaper source of funds than debt.

ANS: F

Suppliers of equity financing face greater risks than suppliers of debt financing because they have only a residual claim in the firm’s earnings. Therefore equity holders require higher rates of return.

PTS: 1 DIF: Difficult REF: *1.2.1(c) Debt versus equity*

22. ADIs are institutions that are authorised to provide traditional banking services.

ANS: T

ADIs include banks, building societies and credit unions that are authorised by APRA to accept deposits, make loans and provide payment services.

PTS: 1 DIF: Moderate REF: *1.3.1 (a) Banks*

23. Superannuation funds provide indirect financing because they collect contributions from workers and arrange the investment of these funds.

ANS: F

Fund management (which includes superannuation) is a direct financing process because the fund manager does not borrow the funds from contributors but rather the ownership of funds remains with investors.

PTS: 1 DIF: Difficult REF: *1.3.1 (c) Insurance companies and fund managers*

24. The money market trades discount securities.

ANS: T

These are securities where the borrower makes a single payment at maturity. In order for the lender/investor to earn interest, the securities will be issued (and subsequently traded) at less than their face (maturity) value.

PTS: 1 DIF: Easy REF: *1.3.2 Australia’s financial markets*

25. Australia has four financial markets that perform the flow-of-funds function – the money market, the bond market, the share market and the foreign exchange market.

ANS: F

The foreign exchange market trades currencies rather than securities used in the flow-of-funds.

PTS: 1 DIF: Moderate REF: *1.3.2 Australia’s financial markets*

26. The Reserve Bank of Australia (RBA) controls Australia’s financial system.

ANS: F

The RBA is responsible for the implementation of monetary policy, among other things, and other regulatory bodies have responsibilities relating to the financial system, but they do not individually or collectively control the financial system.

PTS: 1 DIF: Difficult REF: *1.3.3 The financial regulators*

27. Financial institutions are supervised by the RBA.

ANS: F

The Australian Prudential Regulation Authority (APRA) supervises financial institutions.

PTS: 1 DIF: Easy REF: *1.3.3 The financial regulators*

28. Monetary policy is one tool used by the RBA to enhance financial system stability.

ANS: T

By controlling inflation the RBA creates an environment conducive to economic growth and helps to avoid asset-price ‘bubbles’. The RBA’s regulation of the payment system and monitoring of economic and financial data also contribute to financial system stability.

PTS: 1 DIF: Difficult REF: *1.3.3 (a) The Reserve Bank of Australia*

29. The Australian payments system is overseen by the RBA.

ANS: T

A safe and efficient payments system is essential to financial system stability.

PTS: 1 DIF: Easy REF: *1.3.3(a) The Reserve Bank of Australia*

30. APRA enforces company and financial services laws to protect consumers, investors and creditors.

ANS: F

This function is performed by the Australian Securities and Investments Commission (ASIC).

PTS: 1 DIF: Easy REF: *1.3.3(b) The other regulatory bodies*

31. ‘Sub-prime’ lending refers to loans where the borrower does not meet the normal loan requirements, such as having the capacity to make repayments.

ANS: T

This is a loan category that boomed between 2003 and 2007 in the USA. The loans suffered a high level of defaults, which triggered the GFC.

PTS: 1 DIF: Moderate REF: *1.4.1 The sub-prime housing loan crisis*

32. Investors in mortgage-backed securities used to finance sub-prime loans were well aware of the risks involved.

ANS: F

Investors were not aware of the poor quality of loans that they invested in. Wall Street banks and ratings agencies had an information advantage that they exploited because of financial incentives.

PTS: 1 DIF: Difficult REF: *1.4.2 Securitisation and mortgage-related securities*

33. The GFC saw the mortgage-backed securities market collapse because of the loss of investor confidence.

ANS: T

Investor trust had been violated, and they ceased to supply funds to the market.

PTS: 1 DIF: Moderate REF: *1.4.3 The financial crisis*

34. The sub-prime crisis became a financial crisis because of the collapse of the payment system.

ANS: F

The financial crisis developed because of the contraction in the flow-of-funds. The payment system did not collapse.

PTS: 1 DIF: Moderate REF: *1.4.4 The GFC*

35. Bailouts of loss-making financial institutions pose incentive problems and moral hazards.

ANS: T

It encourages risk-taking behaviour by management on the basis they will be ‘rescued’ should the risks prove unprofitable.

PTS: 1 DIF: Difficult REF: *1.4.5 The bailouts*

**MULTIPLE CHOICE**

1. The improvement in the provision of financial services over time is known as:

|  |  |
| --- | --- |
| A. | financial innovation |
| B. | coincidence of wants |
| C. | deregulation |
| D. | financial conglomerates |
| E. | the global financial system. |

ANS: A PTS: 1 DIF: Moderate REF: *Introduction*

2. According to Merton (1995), financial systems perform six functions. The function performed by the payment system is:

|  |  |
| --- | --- |
| A. | to provide the means for the settlement of commercial transactions |
| B. | to arrange the flow of funds from surplus to deficit units |
| C. | to provide ways for participants in the financial system to transfer and manage risk |
| D. | to promote the pooling of funds |
| E. | to provide ways of dealing with the incentive problems that arise in financial contracting. |

ANS: A PTS: 1 DIF: Easy REF: *1.1.1 The settlement function*

3. Choose the best definition of ‘money’ from the following:

|  |  |
| --- | --- |
| A. | the arrangements that can be used to settle commercial transactions |
| B. | cash |
| C. | the instruments that can be used as a means of exchange |
| D. | the supply of funds from surplus units for use by deficit units. |
| E. | None of these. |

ANS: C PTS: 1 DIF: Difficult REF: *1.1.1 The settlement function*

4. According to Merton (1995), financial systems perform six functions. The flow-of-funds function is:

|  |  |
| --- | --- |
| A. | to provide the means for the settlement of commercial transactions |
| B. | the exchange of funds for a period requiring the user to compensate the supplier for the use of their funds |
| C. | to provide ways for participants in the financial system to transfer and manage risk |
| D. | to overcome information asymmetry |
| E. | to provide ways of dealing with the incentive problems that arise in financial contracting. |

ANS: B PTS: 1 DIF: Easy REF: *1.1.2 The flow of funds function*

5. Direct financing is a situation where:

|  |  |
| --- | --- |
| A. | deficit units raise funds from surplus units |
| B. | surplus units raise funds from deficit units |
| C. | deficit units raise funds from financial intermediaries |
| D. | financial intermediaries obtain funds from surplus units. |
| E. | None of these. |

ANS: A PTS: 1 DIF: Moderate REF: *1.1.2 The flow of funds function*

6. In the Australian financial system, financing is provided by:

|  |  |
| --- | --- |
| A. | derivative and securities markets |
| B. | securities markets and financial intermediaries |
| C. | governments and financial intermediaries |
| D. | derivative markets and financial intermediaries |
| E. | derivative markets, securities markets and financial intermediaries. |

ANS: B PTS: 1 DIF: Moderate REF: *1.1.2 The flow of funds function*

7. According to Merton (1995), financial systems perform six functions. The function that employs the use of derivatives is:

|  |  |
| --- | --- |
| A. | the settlement function |
| B. | the flow of funds function |
| C. | the risk-transfer function |
| D. | to resolve incentive problem |
| E. | to promote the pooling of funds. |

ANS: C PTS: 1 DIF: Easy REF: *1.1.3 The risk-transfer function*

8. Which of the following is NOT an example of market risk?

|  |  |
| --- | --- |
| A. | A share investor whose portfolio has been devastated by a stock-market crash. |
| B. | A loan on which the borrower is unable to make scheduled repayments. |
| C. | A borrower who finds that interest rates in the money market are higher than expected. |
| D. | An importer that has to cope with an unexpected depreciating exchange rate. |
| E. | A fund manager intending to sell at a future date that may face falling share prices. |

ANS: B PTS: 1 DIF: Difficult REF: *1.1.3 The risk-transfer function*

9. Our study of information asymmetry revealed:

|  |  |
| --- | --- |
| A. | It is where one party to a potential contract has an information advantage over the other party. |
| B. | The markets assume professional traders are well informed. |
| C. | Retail investors must be supplied with relevant information to enable a well-informed decision. |
| D. | It can result in contracts that are not mutually beneficial at the expense of the less informed party. |
| E. | All of these. |

ANS: E PTS: 1 DIF: Moderate REF: *1.1.4 Overcoming information asymmetry*

10. A situation where a contract distorts incentives to behave responsibly is known as:

|  |  |
| --- | --- |
| A. | information asymmetry |
| B. | coincidence of wants |
| C. | pooling of funds |
| D. | moral hazard. |
| E. | None of these. |

ANS: D PTS: 1 DIF: Difficult REF: *1.1.5 Overcoming incentive problems*

11. An arrangement that consolidates small amounts of funds to satisfy the demand for large amounts is known as:

|  |  |
| --- | --- |
| A. | financial innovation |
| B. | leverage |
| C. | retail banking |
| D. | coincidence of wants |
| E. | pooling of funds. |

ANS: E PTS: 1 DIF: Easy REF: *1.1.6 Pooling of funds*

12. In reference to the flow of funds from surplus to deficit units, deficit units generally prefer:

|  |  |
| --- | --- |
| A. | high interest rates |
| B. | small amounts |
| C. | contracts with long periods |
| D. | All of these. |
| E. | None of these. |

ANS: C PTS: 1 DIF: Moderate REF: *1.1.6 Pooling of funds*

13. Identify the correct statement about Australia’s financial system.

|  |  |
| --- | --- |
| A. | The main source of funds is household savings. |
| B. | Savings can be in the form of deposits and/or investments. |
| C. | Governments are a source of savings when they have budget surpluses. |
| D. | Firms are a source of savings when they retain earnings. |
| E. | All of these. |

ANS: E PTS: 1 DIF: Difficult REF: *1.2 An introduction to finance*

14. When lenders/investors become very confident, the risk-return function will:

|  |  |
| --- | --- |
| A. | shift upwards |
| B. | shift downwards |
| C. | be relatively steep |
| D. | be relatively flat. |
| E. | None of these. |

ANS: D PTS: 1 DIF: Difficult REF: *1.2 An introduction to finance*

15. The expected return on an investment:

|  |  |
| --- | --- |
| A. | will be negatively related to the risk of the investment |
| B. | will increase when risk-free rate increases, all else being equal |
| C. | is the difference between r risk-free and r risk premium |
| D. | Includes interest and dividends, but not capital gains or losses. |
| E. | All of these. |

ANS: B PTS: 1 DIF: Moderate REF: *1.2 An introduction to finance*

16. Of the following, which is NOT a feature of debt?

|  |  |
| --- | --- |
| A. | Interest payments. |
| B. | Maturity date. |
| C. | Dividends. |
| D. | Security arrangements. |
| E. | Risk premiums. |

ANS: C PTS: 1 DIF: Easy REF: *1.2.1(a) Debt finance*

17. Depending upon the circumstances, equity can also be referred to as:

|  |  |
| --- | --- |
| A. | ordinary shares |
| B. | common stock |
| C. | risk capital |
| D. | shareholders’ funds. |
| E. | All of these. |

ANS: E PTS: 1 DIF: Moderate REF: *1.2.1(b) Equity*

18. The risk borrowers face of not being able to maintain the level of their debt is known as:

|  |  |
| --- | --- |
| A. | credit risk |
| B. | funding risk |
| C. | default risk |
| D. | capital risk |
| E. | market risk. |

ANS: B PTS: 1 DIF: Moderate REF: *1.2.1(c) Debt versus equity*

19. Which of the following is NOT an advantage for a firm of using equity rather than debt financing?

|  |  |  |
| --- | --- | --- |
| A. | Lower cost. |  |
| B. | Lower risk of insolvency. |  |
| C. | Lower funding risks. |  |
| D. | No legal liability to pay dividends. |  |
| E. | No requirement to repay capital. |  |

ANS: A PTS: 1 DIF: Moderate REF: *1.2.1(c) Debt versus equity*

20. The textbook’s coverage of leverage explained its use will:

|  |  |
| --- | --- |
| A. | increase the expected return on equity but not the risk of these returns |
| B. | reduce the risk but not the expected return on equity |
| C. | increase the return on equity as long as the return on assets is less than the cost of debt |
| D. | reduce the risk of bankruptcy. |
| E. | None of these. |

ANS: E PTS: 1 DIF: Difficult REF: *1.2.1(c) Debt versus equity*

21. Which of the following categories of institutions accept deposits from, make loans to and provide payment services for Australian households?

|  |  |
| --- | --- |
| A. | ADIs. |
| B. | Wholesale banks. |
| C. | Investment banks. |
| D. | Insurance companies. |
| E. | Fund managers. |

ANS: A PTS: 1 DIF: Easy REF: *1.3.1(a) Banks*

22. The ‘big four’ (Westpac, Commonwealth bank, NAB and ANZ) are BEST described as:

|  |  |
| --- | --- |
| A. | retail banks |
| B. | financial conglomerates |
| C. | wholesale banks |
| D. | investment banks |
| E. | superannuation schemes. |

ANS: B PTS: 1 DIF: Moderate REF: *1.3.1 (c) Insurance companies and fund managers*

23. Which of the following categories of institutions is best described as providing investment management services?

|  |  |
| --- | --- |
| A. | Retail banks. |
| B. | Wholesale banks. |
| C. | Investment banks. |
| D. | Insurance companies. |
| E. | Fund managers. |

ANS: E PTS: 1 DIF: Easy REF: *1.3.1 (c) Insurance companies and fund managers*

24. Debt financing can be raised by firms in the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_markets.

|  |  |
| --- | --- |
| A. | money and share |
| B. | bond and FX |
| C. | share and derivative |
| D. | money and bond |
| E. | share and FX |

ANS: D PTS: 1 DIF: Moderate REF: *1.3.2 Australia’s financial markets*

25. The financial authority that has responsibility for the protection of consumers, investors and creditors in Australia is:

|  |  |
| --- | --- |
| A. | the Reserve Bank of Australia |
| B. | the Australian Prudential Regulation Authority |
| C. | the Australian Securities and Investments Commission |
| D. | the Australian Treasury |
| E. | the Council of Financial Regulators. |

ANS: C PTS: 1 DIF: Easy REF: *1.3.3 The financial regulators*

26. The financial authority that has responsibility for the stability of the financial system in Australia is:

|  |  |
| --- | --- |
| A. | the Reserve Bank of Australia |
| B. | the Australian Prudential Regulation Authority |
| C. | the Australian Securities and Investments Commission |
| D. | the Australian Treasury |
| E. | the Council of Financial Regulators. |

ANS: A PTS: 1 DIF: Easy REF: *1.1.3 The financial regulators*

27. The boom in ‘sub-prime’ lending (which was the source of the GFC) was motivated by the:

|  |  |
| --- | --- |
| A. | desire to help low-income minority groups |
| B. | belief that the repayment capacity of borrowers had been misrepresented |
| C. | desire for high risk and return investments |
| D. | belief that housing prices would always rise |
| E. | provision of subsidies by the US government. |

ANS: D PTS: 1 DIF: Moderate REF: *1.4.1 The sub-prime housing loan crisis*

28. The securitisation of ‘sub-prime’ loans meant they were sold to investors in:

|  |  |
| --- | --- |
| A. | mortgage-backed securities |
| B. | mortgage-related securities |
| C. | the share market |
| D. | credit-default swaps |
| E. | the money market. |

ANS: A PTS: 1 DIF: Moderate REF: *1.4.2 Securitisation and mortgage-related securities*

29. Which institutions took advantage of information asymmetry in the sale of sub-prime loans to investors in mortgage-backed securities?

|  |  |
| --- | --- |
| A. | The ratings agencies. |
| B. | The Wall Street investment banks. |
| C. | The Federal Reserve. |
| D. | AIG (America’s largest insurer). |
| E. | None of these. |

ANS: B PTS: 1 DIF: Difficult REF: *1.4.2 Securitisation and mortgage-related securities*

30. Mortgage-related securities:

|  |  |
| --- | --- |
| A. | are securities whose value depends on the value of mortgage-backed securities |
| B. | came to be known as ‘toxic securities’ |
| C. | were erroneously rated as being safe (‘AAA’) by the ratings agencies |
| D. | magnified the impact of defaulting sub-prime loans throughout the US financial system. |
| E. | All of these. |

ANS: E PTS: 1 DIF: Difficult REF: *1.4.2 Securitisation and mortgage-related securities*

31. The GFC:

|  |  |
| --- | --- |
| A. | prompted a ‘flight to quality’ that pushed up the interest rate on government securities |
| B. | caused a sharp contraction in lending that prevented many firms from being able to refinance their maturing debt |
| C. | prompted the US government to ‘bail-out’ financial institutions, including Lehman Brothers |
| D. | reinforced the view that markets are ‘self-correcting’ |
| E. | lead to widespread failures of financial institutions in Australia. |

ANS: B PTS: 1 DIF: Difficult REF: *1.4.4 The GFC*

**SHORT ANSWER**

1. Why are financial systems susceptible to crisis?

ANS:

Many financial arrangements rely on the ‘trust’ that parties will honour their financial commitments and that finance professionals will perform their role responsibly. When people lose confidence in the system they will be reluctant to supply funds and this is can trigger a financial crisis.

PTS: 1 DIF: Moderate REF: *Introduction*

1. Explain the term ‘financial innovation’.

ANS:

Financial innovation is the process of improving the provision of financial services. Innovation can occur through the development of new types of financial securities, products or derivatives, or through improvements in technology, such as ATMs and internet banking. Advantages of innovations can include lower cost services and greater functionality and convenience.

PTS: 1 DIF: Moderate REF: *Introduction*

1. Identify the six functions performed by the financial system.

ANS:

The major functions performed by the financial system are:

1. The settlement of commercial transactions by the transfer of money from the buyer to the seller.
2. To arrange the flow of funds from surplus to deficits units, either directly or indirectly.
3. To provide instruments (these are derivative contracts) for managing financial risks.
4. To overcome problems arising from information asymmetry.
5. To avoid problems that can arise from inappropriate incentives.
6. To pool funds from surplus units who typically have small amounts and a preference for liquidity and provide financing to deficit units in larger amounts and for longer terms.

PTS: 1 DIF: Moderate REF: *1.1 Financial functions*

1. What are securities?

ANS:

Securities are financial contracts that specify the obligations of deficits units and the rights of the surplus unit. Examples of securities are bonds and shares.

PTS: 1 DIF: Easy REF: *1.1.2 The flow of funds function*

5. Explain the difference between direct and indirect financing.

ANS:

Direct financing occurs where deficit units raise funds directly from surplus units, usually through the issue of securities in the financial markets. Indirect financing occurs where deposit-taking institutions act as the intermediary between surplus and deficit units. In this situation surplus units lend/invest funds with the intermediary and deficit units borrow funds from the intermediary. As a result, surplus and deficit units deal with each other in an indirect manner.

PTS: 1 DIF: Easy REF: *1.1.2 The flow of funds function*

6. Which contracts can be used to manage financial risks?

ANS:

Derivatives are used for risk management. They are financial contracts whose value is dependent upon another security, market variable or index. This can be to change a risk exposure by hedging (which sets a forward rate or price) or to undertake high risk and return investing known as speculation.

PTS: 1 DIF: Moderate REF: *1.1.3 The risk-transfer function*

7. How do the Australian financial markets address the problem of asymmetric information?

Information asymmetry refers to a situation where one party to a potential contract has an information advantage over the other that they could exploit to the detriment of the less informed party. In markets where only professional, institutional traders participate it is assumed the problem does not exist because these traders are expected to be well informed of the characteristics of the markets in which they trade. In markets where retail investors can trade financial regulations require that information be supplied to the less informed party to allow them to make informed financial decisions. An example of this is the prospectus that is required to accompany share issues.

PTS: 1 DIF: Moderate REF: *1.1.4 Overcoming information asymmetry*

8. Explain the principal source of funds to the Australian financial system and the returns to investors from supplying funds.

ANS:

The main source of funds is savings, most importantly by households when they supply funds as bank deposits and as contributions to superannuation schemes.

Investors earn interest on their bank deposits and on funds invested in debt securities, and will usually receive dividends from their equity securities. In addition, securities that are market traded can change in value and so will produce capital gains and losses.

PTS: 1 DIF: Moderate REF: *1.2 An introduction to finance*

9. Provide a summary of the main features of debt.

ANS:

Debt refers to funds that are loaned or borrowed and this can be conducted under a variety of arrangements, the main provisions being:

* the interest rate and whether it is fixed or floating;
* the terms as to how principal is repaid, for example gradually over the term of the loan or as a lump sum at maturity; and
* whether the risk to the lender is reduced through security provided by the borrower (such as a mortgage).

PTS: 1 DIF: Easy REF: *1.2.1(a) Debt finance*

10. Describe the rights of shareholders in a large company.

ANS:

Shareholders are part-owners of the firm. In large companies owners of ordinary shares typically have the right to vote for the company’s board of directors (and occasionally on other important matters that arise) and to receive dividends if the company decides to pay them.

PTS: 1 DIF: Easy REF: *1.2.1(b) Equity*

11. Discuss the relative risks of debt and equity from the perspective of (i) an investor supplying funds to a firm, and (ii) the firm itself.

ANS:

1. Supplying funds as debt is less risky than supplying funds as equity because the firm is required to pay interest on debt before it is able to make dividend payments to shareholders. Likewise, should the firm be liquidated it is required to repay its debts before making any distributions to owners. Hence it is more risky to supply equity because of its residual claim and thus the required returns on equity will exceed those of debt.
2. The more debt the firm uses, the higher is its risk of insolvency, whereas the use of equity reduces the financial risk of the firm.

PTS: 1 DIF: Moderate REF: *1.2.1(c) Debt versus equity*

12. Explain why equity is a more expensive source of funds for a firm.

ANS:

1. Equity investors have a residual interest in the firm, which means they are paid after payments are made to lenders. This means it is more risky to supply equity funds, and thus the expected returns paid by the firm to shareholders exceeds that paid to lenders.
2. The cash interest payments made to lenders are tax deductible (and therefore reduce the firm’s tax bill) whereas cash dividend payments to shareholders have no such tax advantage.

PTS: 1 DIF: Moderate REF: *1.2.1(c) Debt versus equity*

13. Tom and Ben both intend to invest $50,000 (that they have each received from an inheritance) in Macquarie Group shares that are currently trading at $50 per share. Tom prefers an unlevered investment, whereas Ben decides to borrow a further $50,000 at 10% pa so that he can initially purchase $100,000 in shares. Compare the potential returns and risks for a one year investment (ignoring transaction costs and taxes) for two investors assuming firstly, the share price increases from $50 to $60, and secondly, the share price falls from $50 to $40.

ANS:

(i) The share price increases from $50 to $60.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Tom | |  | Ben | |
| Sell 1000 shares @ $60 each | $60 000 |  | Sell 2000 shares @ $60 each | $120 000 |
| Buy 1000 shares @ $50 each | -50 000 |  | Buy 2000 shares @ $50 each | -100 000 |
|  |  |  | Pay interest of $5 000 | -5 000 |
| Pre-tax earnings | $10 000 |  | Pre-tax earnings | $15 000 |
| Return on equity = 10 000/50 000 = 20% | |  | Return on equity = 15 000/50 000 = 30% | |

The leveraged investment results in a higher return on equity because the return on the additional shares purchased exceeds the cost of the debt.

(ii) The share price falls from $50 to $40.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Tom | |  | | Ben | |
| Sell 1000 shares @ $40 each | $40 000 |  | | Sell 2000 shares @ $40 each | $80 000 |
| Buy 1000 shares @ $50 each | -50 000 |  | | Buy 2000 shares @ $50 each | -100 000 |
|  |  |  | | Pay interest of $5 000 | -5 000 |
| Pre-tax loss | -$10 000 |  | | Pre-tax earnings | -$25 000 |
| Return on equity = -10 000/50 000 = -20% | | |  | Return on equity = -25 000/50 000 = -50% | |

Leverage increases both the potential risk and return to equity holders.

PTS: 1 DIF: Difficult REF: *1.2.1(c) Debt versus equity*

14. Define leverage and briefly explain the risks posed by it.

ANS:

Leverage refers to the use of debt financing and can be measured by the ratio of an investment’s (or firm’s) assets to equity capital. The risks faced by a firm taking on greater levels of debt include:

* Leverage magnifies the impact of poor returns.
* Funding risks exist when debt needs to be rolled-over (to extend its term) but circumstances (such as the GFC) make this difficult.
* When loans are secured, there is the risk of forced asset sales by lenders if the borrower defaults on loan payments.
* The risk that forced asset sales will fail to achieve fair values.

PTS: 1 DIF: Moderate REF: *1.2.1(c) Debt versus equity*

15. What is an ADI? What services do they provide?

ANS:

An ADI is an authorised deposit-taking institution. These are institutions that have authorised by APRA to provide indirect financing services to the public and include banks, building societies and credit unions.

As providers on indirect financing services they will accept deposits, make loans and provide payment services to their retail and/or wholesale customers (though their operations are not limited to these activities).

PTS: 1 DIF: Easy REF: *1.3.1 Australia’s financial institutions*

16. Identify and briefly describe the ‘non-bank’ financial institutions.

ANS:

These are institutions that principally provide direct financing activities. Merchant and investment banks are non-ADI institutions that provide direct financing services to their wholesale (or big business) customers. Mortgage originators provide housing loans to retail borrowers with funds raised from the issue of mortgage-backed securities in the financial markets.

PTS: 1 DIF: Moderate REF: *1.3.1 (b)* *Non banks*

17. Provide a brief overview of Australia’s financial markets in terms of the financial functions they perform.

ANS:

Australia has three markets that arrange the flow-of-funds. The money market is a market for short-term debt securities where the borrower makes a single payment to the lender on the security’s maturity date. The bond market is a market for long-term debt where the borrower typically pays regular payments of interest and redeems the bond by repaying its face value on its maturity date. The share market is a market for equity and these securities are usually perpetual.

The foreign exchange market arranges the trading in currencies which enables firms to trade with, invest in and borrow from other countries.

We also have markets for derivative contracts that perform the financial system’s risk-transfer function. These contracts can be used to reduce a particular risk exposure (hedging) or to increase a particular risk exposure (speculation).

PTS: 1 DIF: Moderate REF: *1.3.2 Australia’s financial markets*

18. Briefly outline the main functions of the RBA.

ANS:

The RBA is responsible for the implementation of monetary policy, the stability of the financial system, the regulation of the payment system, the issue of currency and acts as a banker for the Commonwealth Government.

PTS: 1 DIF: Easy REF: *1.3.3(a) The Reserve Bank of Australia*

19. The GFC is sometimes referred to as a ‘crisis of confidence’. Explain the role of confidence leading up to and during the crisis.

ANS:

In the period prior to the crisis, lenders were over-confident about the ability of some borrowers to repay loans and so were prepared to lend to risky borrowers at credit-risk premiums that were too small. Some lenders sought higher returns by using derivatives whilst underestimating the risks involved.

The onset of the crisis saw lenders rapidly lose confidence that borrowers would make their repayments. Many of these loans were funded in the security markets and the value of these securities fell by large amounts as investors fled the market. Institutions became reluctant to lend to each other, with concerns about exposure to losses. Overall, the loss of confidence lead to steep increases in risk premiums, or the cessation of lending altogether.

PTS: 1 DIF: Difficult REF: *1.4 The global financial crisis*

20. Explain the flaws in ‘sub-prime’ lending in the US and how it contributed to the GFC.

ANS:

Sub-prime loans are those made to borrowers with a questionable repayment capacity. They would often have a low interest rate initially that would be reset to a much higher rate that many of the borrowers would not be able to afford. Lenders were motivated by the belief that housing prices would continue to rise, allowing loan defaulters to refinance their loans, or the lender to recoup their investment through repossessions. However the boom in construction fuelled by sub-prime loans reduced property prices, the falls gained momentum as lenders sold repossessed properties and lead to borrowers deliberately defaulting on their loans.

The losses that were realised on sub-prime loans flowed-through to the investors in MBS that financed the loans. Investors in the securities had been misled regarding their risk and lost confidence in the markets when large losses were realised on their supposedly ‘safe’ investments.

PTS: 1 DIF: Difficult REF: *1.4.1 The sub-prime housing loan crisis*

21. Briefly explain three consequences of the GFC on Australia.

ANS:

Some of the consequences of the GFC in Australia were:

* Large falls in the value of share prices.
* Higher interest costs and increased difficulty in borrowing from the financial markets locally and particularly in offshore markets. This lead to the failure of some Australian firms who were unable to rollover debt.
* Reduced taxation receipts and increased expenditure on stimulus packages (to avoid recession) resulting in Commonwealth government budget deficits.

PTS: 1 DIF: Difficult REF: *1.4 The global financial crisis*

**ESSAY**

1. Explain the six functions performed by the financial system.

ANS:

Essay answers will need to be individually marked.

PTS: 1 DIF: Easy REF: *1.1 Financial functions*

2. Explain the risk transfer function, carefully describing the main categories of risk.

ANS:

Essay answers will need to be individually marked.

PTS: 1 DIF: Moderate REF: *1.1.3 The risk-transfer function*

3. Explain the two main forms of finance (debt and equity).

ANS:

Essay answers will need to be individually marked.

PTS: 1 DIF: Easy REF: *1.2.1 The two basic forms of finance*

4. Outline the differences between debt and equity as forms of finance.

ANS:

Essay answers will need to be individually marked.

PTS: 1 DIF: Moderate REF: *1.2.1 The two basic forms of finance*

5. Describe the institutions and markets within Australia’s financial system.

ANS:

Essay answers will need to be individually marked.

PTS: 1 DIF: Moderate REF: *1.3 The structure of Australia’s financial system*

6. Provide a brief overview of the GFC.

ANS:

Essay answers will need to be individually marked.

PTS: 1 DIF: Moderate REF: *1.4 The global financial crisis*

7. Explain how the flow-of-funds function and risk-transfer function were impaired during the GFC.

ANS:

Essay answers will need to be individually marked.

PTS: 1 DIF: Difficult REF: *1.4 The global financial crisis*

8. What role did incentive problems play in the GFC?

ANS:

Essay answers will need to be individually marked.

PTS: 1 DIF: Difficult REF: *1.4 The global financial crisis*