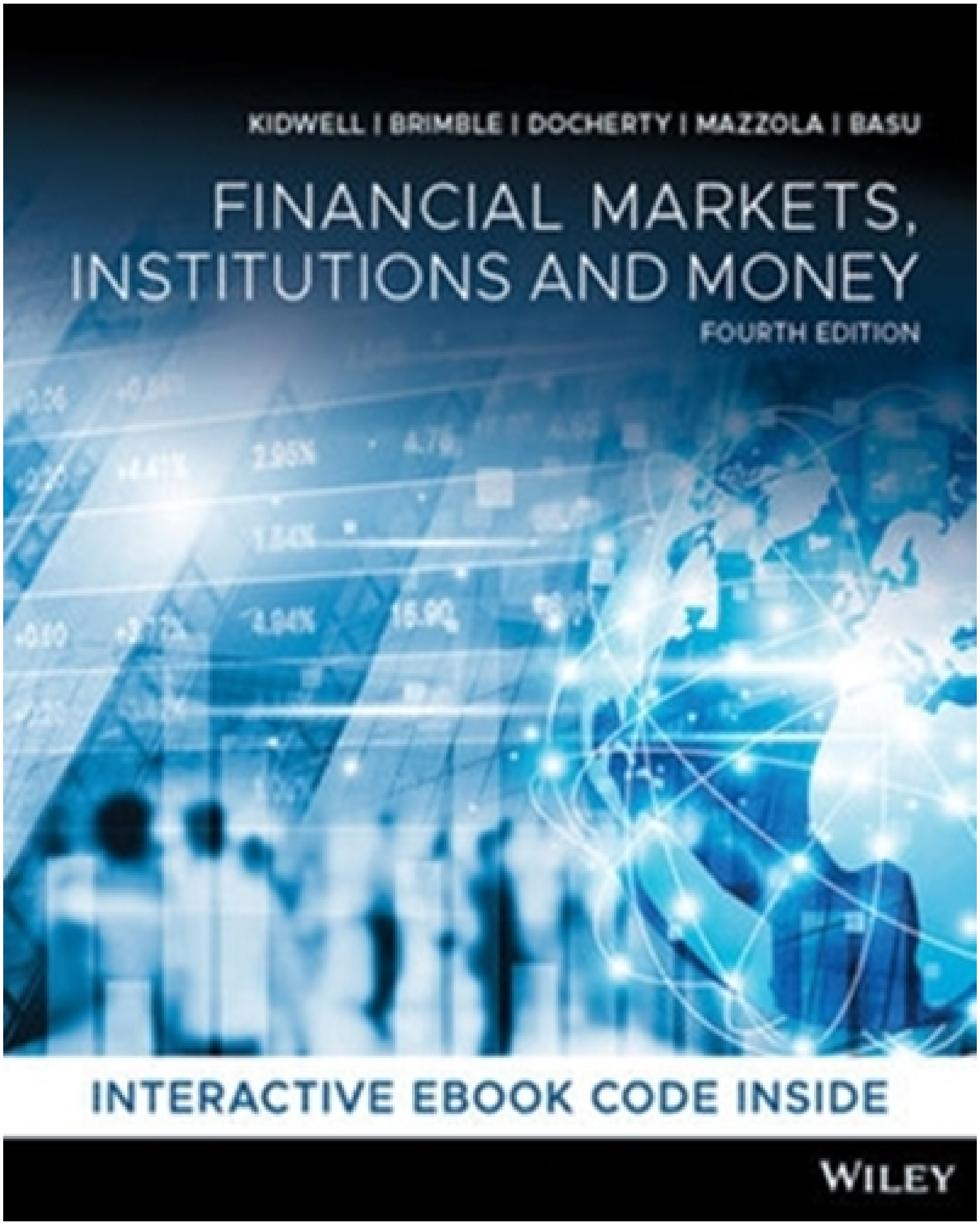
Solutions for Financial Markets Institutions and Money 4th Edition by Kidwell



Solutions

Solutions manual

to accompany

Financial markets, institutions and money

4th edition

by

Kidwell et al.

WILEY

Chapter 1: The financial system

Questions and problems

BASIC

1.1 Financial system: What is the role of the financial system, and what are the two major components of the financial system?

The role of the financial system is to gather money from businesses and individuals and to channel funds to those who need them. The financial system consists of financial markets and financial institutions.

1.2 Financial system: What does a competitive financial system imply about interest rates?

If the financial system is competitive, one will receive the highest possible rate for money invested with a bank and the lowest possible interest rate when borrowing money. Also, only companies with good credit ratings and projects with high rates of return will be financed.

1.3 Financial system: What is the difference between saver–lenders and borrower–spenders, and who are the major representatives of each group?

Saver–lenders are those who have more money than they need right now. The principal saver–lenders in the economy are households. Borrower–spenders are those who need the money saver–lenders are offering. The main borrower–spenders in the economy are businesses, although households are important mortgage borrowers.

1.4 Financial markets: List the two ways in which a transfer of funds takes place in an economy. What is the main difference between these two?

Funds can flow directly through financial markets or indirectly through intermediation markets where funds flow through financial institutions first.

1.5 Financial markets: Suppose you own a security that you know can be easily sold in the secondary market, but the security will sell at a lower price than you paid for it. What would this mean for the security's marketability and liquidity?

As the price of the security is lower than that you paid for it, it has a lower degree of liquidity to you, the owner. That is because the security cannot now be sold without a loss in value to the owner. Marketability refers to the ease to which a security can be sold or converted to cash. The information in the problem does mention a drastically lower price and so we must conclude that the security's marketability in not affected.

1.6 Financial markets: Why are the direct financial markets also called wholesale markets?

The financial markets are also called wholesale markets because the minimum transaction or security denomination is $1 million or more.

1.7 Financial markets: Tinker Pty Ltd is a $300 million company, as measured by asset value, and Horst Pty Ltd is a $35 million company. Both are privately held companies. Explain which company is more likely to go public and list on the ASX, and why.

Tinker Pty Ltd is more likely to go public. Going through an IPO is a very expensive process, and given Tinker's higher worth, they are more likely to be positioned to go through with it.

1.8 Primary markets: What is a primary market? What does IPO stand for?

A primary market is where new securities are sold for the first time. IPO stands for initial public offering.

1.9 Primary markets: Identify whether the following transactions are primary market or secondary market transactions.
a. Jim Hendry bought 300 shares of AGL Energy through his share broker.
b. Candy How bought $5,000 of AGL Energy bonds from the company.
c. Hathaway Insurance Company bought 500,000 shares of AGL Energy when the company issued shares.

a. Secondary.
b. Secondary.
c. Primary.

1.10 Investment banking: What does it mean to 'underwrite' a new security issue? What compensation does an investment banker get from underwriting a security issue?

To underwrite a new security issue means that the investment banker guarantees the amount the company wishes to raise in the issue. Any unsold securities are then purchased by the underwriter at the offer price less an underwriting spread and then on sold in the market. In addition to underwriting new securities, investment banks also provide other services, such as preparing the prospectus and other legal documents to be lodged with ASIC, and providing general financial advice to the issuer.

MODERATE

1.11 Investment banking: Cranbourne Ltd is issuing 10,000 bonds, and its investment banker has guaranteed a price of $985 per bond. The investment banker sells the entire issue to investors for $10,150,000.
a. What is the underwriting spread for this issue?
b. What is the percentage underwriting cost?
c. How much did Cranbourne raise?

a. $300,000 ($10,150,000 – $985 x 10,000)
b. 3.05 per cent ($30/$985)
c. $9,850,000 ($985 x 10,000)

1.12 Financial institutions: What are some of the ways in which a financial institution or intermediary can raise money?

A financial intermediary can raise money through the sale of financial products that individuals or businesses will purchase, such as cheque and savings accounts, life insurance policies, or superannuation funds.

1.13 Financial institutions: How do financial institutions act as 'intermediaries' to provide services to small businesses?

Financial intermediation is the process whereby borrowing occurs indirectly from a financial institution that has converted financial securities with one set of characteristics into securities with another set of characteristics for the borrower’s specific need.

1.14 Financial institutions: Which financial institution is usually most important to businesses?

The primary financial intermediaries are commercial banks, life and general insurance companies, superannuation funds, and finance companies. Commercial banks are the largest and most prominent financial intermediaries in the economy and offer the widest range of financial services to businesses.

1.15 Financial markets: What is the main difference between money markets and capital markets?

Money markets are markets in which short-term debt instruments with maturities of less than one year are bought and sold. Capital markets are markets in which equity securities and debt instruments with maturities of more than one year are sold.

1.16 Money markets: What are Australian government Treasury notes?

Treasury notes are a money market instruments issue by the Australian government to meet short term liquidity needs. Money market instruments are lower in risk than other securities because of their high liquidity and low default risk.

1.17 Money markets: Besides Treasury notes, what are other money market instruments?

Other common money market instruments include commercial paper, bank accepted bills, bank negotiable CDs, and other marketable short-term securities.

1.18 Money markets: What is the primary role of money markets? How do money markets work?

Money markets provide an option for large companies to adjust their liquidity positions. Since only seldom are cash receipts and cash expenditures perfectly synchronised, money markets allow companies to temporarily invest idle cash in Treasury notes or bank accepted bills. If a company is short on cash, it can borrow the money from money markets by selling commercial paper at lower interest rates than borrowing through commercial banks.

1.19 Capital markets: How do capital market instruments differ from money market instruments?

Capital market instruments are less liquid or marketable, they have longer maturities, usually between 1 and 30 years, and they carry more financial risk.

1.20 Capital markets: What are the major differences between public and private markets?

Public markets are organised financial markets where the public buys and sells securities through their share brokers. In contrast, private markets involve direct transactions between two parties. ASIC regulates both public and private securities markets in Australia.

1.21 Financial instruments: Explain the two risk-hedging instruments discussed in the module.

The two risk-hedging instruments discussed are futures contracts and options.

1.22 Market efficiency: Define operational efficiency.

Operational efficiency focusses on bringing buyers and sellers together at the lowest possible cost. That is, it is the market situation in which the costs of conducting transactions are as low as possible.

1.23 Market efficiency: What will happen to market prices if transaction costs are high?

If transaction costs are high, market prices will be more volatile, fewer financial transactions will take place and prices will not reflect the knowledge and expectations of investors as accurately.

1.24 Market efficiency: What costs are associated with a markets operational efficiency?

The costs associated with a markets operational efficiency are called transaction costs. Transaction costs include broker commissions and other fees and expenses of bringing buyers and sellers together.

1.25 Market efficiency: Why is it important to the broader economy to have an efficient and effective financial system?

A well-developed financial system is critical for the operation of a complex economy such as that of Australia as it facilitates commercial, retail and government transactions in a timely, low cost and reliable way. An economy cannot function efficiently without a competitive and sound financial system that gathers money and channels it into the best investment opportunities. An efficient and effective financial system will also produce actual and timely information to enable effective financial decision making, which is also important in the complex financial world of today.