INSTITUTE OF ACTUARIAL & QUANTITATIVE STUDIES

Subject: Introduction to Derivatives & Financial Markets

Chapter: Introduction to Financial Systems

Category: Practice Questions

1. Which of the following is not a function of the financial market/

A. Mobilization of funds
B. Pricing of securities
C. Floating of companies
D. Lower transaction Costs

2. Primary and Secondary markets develop simultaneously because they

A. Complement each other
B. Control each other
C. Compete with each other
D. Function independently

3. Providing liquidity is an important function of financial markets. True or False

A. False
B. True

4. Which of the following is not a function of the financial system?

A. To regulate arbitrageurs' profits (excess returns).
B. To help the economy achieve allocational efficiency.
C. To facilitate borrowing by businesses to fund current operations.

5. The government of a country whose financial markets are in an early stage of development has hired you as a consultant on financial market regulation. Your first task is to prepare a list of the objectives of market regulation. Which of the following is least likely to be included in this list of objectives?

A. Minimize agency problems in the financial markets.
B. Ensure that financial markets are fair and orderly.
C. Ensure that investors in the stock market achieve a rate of return that is at least equal to the risk-free rate of return.

Short Answers

1. Give any two characteristics of secondary market.

2. What is meant by ‘primary market’?

3. It is an institution which provides a platform for buying and selling of existing securities. Mention it.

4. Explain Capital Market. Give two parts of capital market.

5. Differentiate between the two segments of financial market on any five basis.

Answers

1. Ans: C

2. Ans: A

3. Ans: B

4. Ans: A

Regulation of arbitrageurs’ profits is not a function of the financial system. The financial system facilitates the allocation of capital to the best uses and the purposes for which people use the financial system, including borrowing money.

5. Ans: C

Ensure that investors in the stock market achieve a rate of return that is at least equal to the risk-free rate of return is least likely to be included as an objective of market regulation. Stocks are risky investments and there would be occasions when a stock market investment would not only have a return less than the risk-free rate but also a negative return. Minimizing agency costs and ensuring that financial markets are fair and orderly are objectives of market regulation.

Short Answers

1) The two characteristics of secondary market are : i. It creates liquidity, ii. It has a particular place.

2) Primary market is the market in which firms sell (float) new stocks and bonds to the public for the first time. Therefore, it is also Is known as ‘New Issue Market’ (NIM).

3) Stock exchange- Organized and regulated financial market where securities (bonds, notes, shares) are bought and sold at prices governed by the forces of demand and supply.

4) “Capital Markets” refers to activities that gather funds from some entities and make them available to other entities needing funds. The core function of such a market is to improve the efficiency of transactions so that each individual entity doesn’t need to do search and analysis, create legal agreements, and complete funds transfer.

The two parts of Capital Market are: i. Primary Market ii. Secondary Market

5)

Basis	Capital market	Money market
Meaning	It refers to the whole network of organisations, institutions and instruments that deal in medium and long-term funds.	Money market is a market for short-term funds which deals in monetary assets whose period of maturity is upto one year
Liquidity	Only actively traded securities have ready market.	In this market, there is a formal arrangement of creating liquidity
Duration	Period of maturity is more than one year	Period of maturity ranges from one day to one year.
Expected Return	The expected returns are high as there is scope of earning capital gains and long-term prosperity is also shared by the company in form of high dividends and bonus issues.	The expected return is less due to short duration and lower risk.
Investment Outlay	Investment outlay does not necessarily require huge investment outlay. The unit prices is low, i.e. Rs10, Rs100	Money market transactions entail huge sums of money as instruments are quite expensive.

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	and so even the trading lots are small, i.e. 5, 50, 100 etc.	
Participants	Individual investors, as well as institutional investors like financial institutions, banks, corporate houses and foreign investors, participate in the capital market transactions.	The participants are RBI, Commercial Banks financial institutions, mutual funds and corporate houses. Individual investors do not participate in money market

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