**TCHE 303 – MONEY AND BANKING**

**TUTORIAL 5**

1. What kind of moral hazard problems do banks worry about? **Borrowers do not use the loan in an appropriate way that has been agreed in the restrictive covenant.**
2. Describe two ways in which financial intermediaries help lower transaction costs in an economy. **Develop expertise in computer technology + purchase large amount of stocks or bonds with the fund given by the shareholders**
3. Why are financial intermediaries willing to engage in information collection activities when investors in financial instruments may be unwilling to do so? **Investors in financial instruments who engage in information collection face a free-rider problem, which means other investors may be able to benefit from their information without paying for it /// Fin intermediaries willing to do that bc they will reap all the benefits from in4 collecting**
4. Suppose you go to your local bank, intending to buy a certificate of deposit with your savings. Explain why you would not offer a loan, at an interest rate that is higher than the rate the bank pays on certificates of deposit (but lower than the rate the bank charges for car loans), to the next individual who enters the bank and applies for a car loan. **Suppose you go to the bank to buy a certificate of deposit with your savings. Now suppose you see an individual applying for a car loan, and you consider giving your savings as a loan to him to buy a car rather than buying a certificate of deposit. The loan is offered at an interest rate higher than that offered by a certificate of deposit but lower than the rate charged by the bank on car loans. The deposit with the bank, in this case, though offers a low return on your savings but is less risky. The loan to an unknown individual gives a higher return but is risky as you do not know the individual's credibility. You would prefer giving the loan to the individual based on how you value return on investment and the credit risk. If the extra risk taken by loaning out the amount is worth the extra return, then you would prefer to offer a car loan to the individual.**
5. Wealthy people often worry that others will seek to marry them only for their money. Is this a problem of adverse selection? **Yes, wealthy people face an adverse selection problem before they marry. Many of the people most interested in marrying a rich person are motivated more by money than love. Thus, rich people should be extra careful to screen out those who want to marry for money from those who want to marry for love**.
6. Do you think the lemons problem would be more severe for stocks traded on the New York Stock Exchange or for those traded over-the-counter? Explain. **: The lemons problem would be less severe for firms listed on the NYSE because they are typically larger corporations which are better known in the market place. Therefore it is easier for investors to get information about them and figure out whether the firm is of good quality or is a lemon. This makes the adverse selection-lemons problem less severe**
7. Would you be more willing to lend to a friend if she had put all of her life savings into her business than you would be if she had not done so? Why?
8. What specific procedures do financial intermediaries use to reduce asymmetric information problems in lending? **- Banks screen potential borrowers before making loans. - Monitor borrowers' financial conditions and how they are using borrowed funds after making loans.**
9. What steps can the government take to reduce asymmetric information problems and help the financial system function more smoothly and efficiently**? establishing appropriate communication channels, vetting material, and explaining norms and regulations**
10. How can asymmetric information problems lead to a bank panic? **The asymmetric information theory suggests that depositors will precipitate a bank run if they receive a negative signal about the quality of the bank's loans. Thus, each panic should have been preceded by a large negative real shock.**
11. In December 2001, Argentina announced it would not honor its sovereign (government-issued) debt. Many investors were left holding Argentinean bonds priced at a fraction of their previous value. A few years later, Argentina announced it would pay back 25% of the face value of its debt. Comment on the effects of information asymmetries on government bond markets. Do you think investors are currently willing to buy bonds issued by the government of Argentina?
12. How does the free-rider problem aggravate adverse selection and moral hazard problems in financial markets?
13. Would moral hazard and adverse selection still arise in financial markets if information were not asymmetric? Explain.
14. How do standardized accounting principles help financial markets work more efficiently?
15. Which firms are most likely to use bank financing rather than issue bonds or stocks to finance their activities? Why?
16. How can the existence of asymmetric information provide a rationale for government regulation of financial markets?
17. “The more collateral there is backing a loan, the less the lender has to worry about adverse selection.” Is this statement true, false, or uncertain? Explain your answer.
18. Explain how the separation of ownership and control in American corporations might lead to poor management.
19. Gustavo is a young doctor who lives in a country with a relatively inefficient legal and financial system. When Gustavo applied for a mortgage, he found that banks usually required collateral for up to 300% of the amount of the loan. Explain why banks might require that much collateral in such a financial system. Comment on the consequences of such a system for economic growth.
20. Why does the government find it necessary to heavily regulate the financial system? Give one example of such government involvement into financial markets.
21. Life insurance companies tend to invest in long-term assets such as loans to manufacturing firms to build factories or to real estate developers to build shopping malls and skyscrapers. Automobile insurers tend to invest in short-term assets such as Treasury bills. What accounts for these differences?
22. List three types of financial intermediaries, give examples.
23. Joe and Mike purchase identical houses for $200,000. Joe makes a down payment of $40,000, while Mike only puts down $10,000; for each individual, the down payment is the total of his net worth. Assuming everything else is equal, who is more highly leveraged? If house prices in the neighborhood immediately fall by 10 percent (before any mortgage payments are made), what would happen to Joe’s and Mike’s net worth?
24. You decide to start a business selling covers for smartphones in a mall kiosk. To buy inventory, you need to borrow some funds. Why are you more likely to take out a bank loan than to issue bonds?
25. Why do large corporations find it easier to raise funds in securities markets while small businesses rely mostly on bank loans?
26. Will finance companies be replaced by commercial banks?
27. Discuss the following: Money market funds attract money from investors who do not know what else to do with their money. Thus money market funds are merely a last resort when there are no better alternatives for investment. Since they invest only in short term securities, they do not play a role in financing economic growth.
28. Why can a money market mutual fund allow its shareholders to redeem shares at a fixed price but other mutual funds cannot?
29. Should financial institutions be regulated in order to reduce their risk? Offer at least one argument for regulation and one argument against regulation.