An Economic Analysis of Financial Structure
ECON 4673
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Problems

1. What are the six basic facts about the financial system?

2. Why are financial intermediaries/banks willing to engage in information collection activities when investors in financial instruments may be unwilling to do so?

3. Wealthy people often worry that others will seek to marry them only for their money. Is this a problem of adverse selection?

4. 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?

5. What types of restrictive covenants can be included in debt contracts?

6. In December 2001, Argentina announced it would not honor its 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?

7. Would moral hazard and adverse selection still arise in financial markets if information were not asymmetric? Explain.

8. Which firms are most likely to use bank financing rather than issuing bonds or stocks to finance their activities? Why?

9. "The more collateral there is backing a loan, the less the lender has to worry about adverse selection." Is this statement true or false? Explain your answer.

10. You own a house worth $400,000 that is located on a river. If the river floods moderately, the house will be completely destroyed. Moderate flooding happens about once every 50 years. If you build a seawall, the river would have to flood heavily to destroy your house, and such heavy flooding occurs only about once every 200 years. What would be the annual premium for a flood insurance policy that offers full coverage (100% of the value) for both with and without the seawall? How is your answer different if the insurance policy pays only 75% of the home value? You can assume the insurance company charges you a premium equal to the expected loss to the insurer.