Quiz #3
Emerging Financial Markets

1. Name two types of Asymmetric Information Problems

   Adverse Selection Problems

   Moral Hazard Problems

2. What is the Principal-Agent Problem? How can firms mitigate this problem?

   A moral hazard problem in which the Agent (manager) of a firm lacks incentives to act in the best interest of the Principal (owner) of the firm. As a result the manager will maximize his/her utility which, in general, will not maximize the profits of the firm.

3. When banks are Lenders they face Adverse Selection and Moral Hazard problems. How do they mitigate each of these?

   Adverse Selection:
   - *Screen*
   - *Require collateral*

   Moral Hazard:
   - *Monitor*
   - *Require collateral*

4. When banks are Borrowers, who faces Adverse Selection and Moral Hazard Problems? How are these mitigated?
   <u>*The Depositors*</u>

   Adverse Selection:
   - *Deposit Insurance*
   - *Produce information on soundness of bank*
   - *Require high capital*

   Moral Hazard:
   - *Monitor bank, obtain information on probability of default*
   - *Deposit Insurance*
   - *Require high capital*