MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) Because of the "lemons problem" the price a buyer of a used car pays is
   A) less than the price of a lemon.
   B) between the price of a lemon and a peach.
   C) equal to the price of a peach.
   D) equal to the price of a lemon.

2) By bundling share purchases of many investors together mutual funds can take advantage of economies of scale and thereby lower
   A) transactions costs.
   B) moral hazard.
   C) adverse selection.
   D) diversification.

3) If bad credit risks are the ones who most actively seek loans then financial intermediaries face the problem of
   A) free-riding.
   B) adverse selection.
   C) moral hazard.
   D) costly state verification.

4) Property that is pledged to the lender in the event that a borrower cannot make his or her debt payment is called
   A) interest.
   B) good faith money.
   C) points.
   D) collateral.

5) A clause in a mortgage loan contract requiring the borrower to purchase homeowner’s insurance is an example of a
   A) restrictive covenant.
   B) proscriptive covenant.
   C) constraint-imposed covenant.
   D) prescriptive covenant.

6) The principal-agent problem would not occur if ______ of a firm had complete information about actions of the _______.
   A) owners; customers
   B) managers; customers
   C) managers; owners
   D) owners; managers

7) For restrictive covenants to help reduce the moral hazard problem they must be ______ by the lender.
   A) easily changed
   B) impossible to remove
   C) written in all capitals
   D) monitored and enforced

8) Of the sources of external funds for nonfinancial businesses in the United States, loans from banks and other financial intermediaries account for approximately ______ of the total.
   A) 6%
   B) 40%
   C) 56%
   D) 60%
9) Moral hazard in equity contracts is known as the ______ problem because the manager of
the firm has fewer incentives to maximize profits than the stockholders might ideally prefer.
A) free-rider  B) debt deflation
C) principal-agent  D) adverse selection

10) A borrower who takes out a loan usually has better information about the potential returns
and risk of the investment projects he plans to undertake than does the lender. This inequality
of information is called
A) noncollateralized risk.  B) moral hazard.
C) asymmetric information.  D) adverse selection.

11) Of the following sources of external finance for American nonfinancial businesses, the least
important is
A) loans from banks.
B) loans from other financial intermediaries.
C) stocks.
D) bonds and commercial paper.

12) Credit card debt is
A) unrestricted debt.  B) restricted debt.
C) secured debt.  D) unsecured debt.

13) A lesson of the Enron collapse is that government regulation
A) always fails.
B) can reduce but not eliminate asymmetric information.
C) increases the problem of asymmetric information.
D) should be reduced.

14) Equity contracts account for a small fraction of external funds raised by American businesses
because
A) of the reduced scope for moral hazard problems under equity contracts, as compared to
debt contracts.
B) costly state verification makes the equity contract less desirable than the debt contract.
C) equity contracts do not permit borrowing firms to raise additional funds by issuing debt.
D) there is no moral hazard problem when using a debt contract.

15) The problem faced by the lender that the borrower may take on additional risk after receiving
the loan is called
A) adverse selection.  B) transactions costs.
C) diversification.  D) moral hazard.

16) The free-rider problem occurs because
A) people who do not pay for information use it.
B) it is never profitable to produce information.
C) people who pay for information use it freely.
D) information can never be sold at any price.
17) The reduction in transactions costs per dollar of investment as the size of transactions increases is
   A) economies of trade.          B) economies of scale.
   C) discounting.                 D) diversification.

18) One possible reason for slower growth in developing and transition countries is
   A) strict accounting standards are too stringent for the banks to meet.
   B) the weak link between government and financial intermediaries.
   C) capital may not be directed to its most productive use.
   D) the lack of adverse selection and moral hazard problems.

19) Collateralized debt is also known as
   A) secured debt.          B) promissory debt.
   C) unsecured debt.       D) unrestricted debt.

20) The "lemons problem" exists because of
   A) transactions costs.          B) asymmetric information.
   C) rational expectations.       D) economies of scale.

21) Net worth can perform a similar role to
   A) economies of scale.          B) diversification.
   C) collateral.                 D) intermediation.

22) American businesses get their external funds primarily from
   A) bonds and commercial paper issues.
   B) stock issues.
   C) loans from nonbank financial intermediaries.
   D) bank loans.
Answer Key
Testname: CH08

1) B
2) A
3) B
4) D
5) A
6) D
7) D
8) C
9) C
10) C
11) C
12) D
13) B
14) B
15) D
16) A
17) B
18) C
19) A
20) B
21) C
22) C