Exercise 6

1. Explain how aysmmetric information can adversely affect the operation of the capital market. Can financial intermediary resolve this problem more efficiently? (Question 4, Peter D. Spencer, P.174)

2. How can confidential nature of their business help financial intermdiaries to win business from large frms? when can a bank loan agreement act as a signal to the capital market? (Question 6, Peter D. Spencer, P.175)

3. Critically assess the respective merits of the 'signalling' and 'delegated monitoring' models of financial intermediation..

4. Consider the Diamond's (1984) model of financial intermediation as delegated monitoring. Reminder of the notation used in the lecture: n firms, each firm needs m units of investment, nm small lenders, returns $\tilde{y}$ observed only by firms, monitoring cost K, nonpecuniary cost P.

4a) Describe the moral hazard problem which the firm is facing. Write down two possible mechanisms which may be used to solve this moral hazard problem.

4b) What would be the total monitoring cost of the economy by direct lending?

4c) Given that the optimal nonpecuniary cost for the bank is $\widetilde{P}$. What would be the total monitoring cost of the economy by intermediated financing?

4d) If n is large enough, intermediated finance (bank finance) has a lower total monitoring cost than direct lending. Do you agree? Discuss the benefit of diversification and economies of scale in banking.

Students do not have to submit this execise. There is no mark for submitting. This is a typical examination question for which there are many "correct" answers of varying standards.