Finance 4335 Moral Hazard and Adverse Selection Synopsis Outline and Study Questions

Here is a summary of the key points from the *Moral Hazard & Adverse Selection Synopsis*, along with Study Questions and Answers:

Moral Hazard

- Arises from separation of ownership and control in principal-agent relationships
- Agent may not act in the principal's best interest since monitoring is limited.
- Found in corporate governance, corporate finance, insurance, law, and social contexts
- Solutions involve proper management of incentives and risk-sharing
- Keys to incentive contracts:
    - A tradeoff exists between risk sharing and motivation
    - Less than fully efficient risk-sharing
    - Monitoring costs vs. risk burden costs
    - Outcomes depend on agent's efforts
    - Measurable and verifiable outcomes

Adverse Selection

- Arises from information asymmetry between two parties
- An informed party may exploit an uninformed party
- Strategies:
    - Risk classification
        - Credit scores, risk modeling
    - Signaling
        - Certification, warranties, dividends
    - Self-selection contract design
        - Offer contract menu to incentivize revelation of risk type

Questions	Answers
What is moral hazard?	When an agent acts in their own interest rather than the principal's interest due to lack of monitoring
What causes adverse selection?	Information asymmetry between two parties
Name two contexts where moral hazard arises.	Corporate governance (owner-manager), insurance (insurer-policyholder); other contexts include corporate finance (creditor-owner), civil litigation (client-lawyer), and society-firm relationships in broader stakeholder context.
How can adverse selection be mitigated?	Risk classification, signaling, self-selection contract design
Give an example of signaling.	Credible third-party certification enables agents to signal quality; e.g., creditors pay rating agencies to certify creditworthiness, and students signal human capital quality by attending and graduating from high-quality colleges and universities.