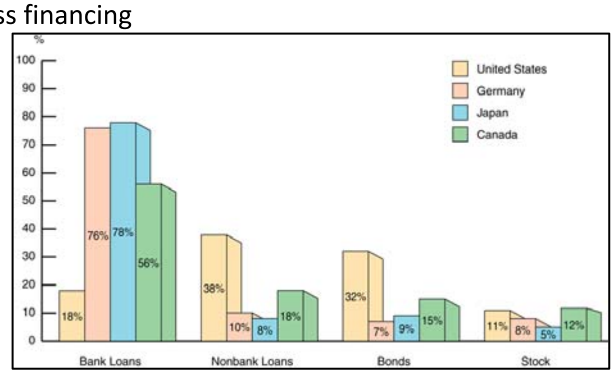
<u>Asymmetric Information (11/23/2010)</u>   Econ 310-004

<u>Definitions</u>

- ***transaction costs*** – time & money spent trying to exchange financial assets, goods, or services
- ***financial intermediaries*** – institutions that borrow funds from savers and make loans to others
- ***asymmetric information*** – unequal knowledge each party to a transaction has about the other party
- ***adverse selection*** – ex-ante (*before* transaction) asymmetric information; the most undesirable people (from the other party's point of view) are the ones most likely to want to engage in financial transaction
- ***moral hazard*** – ex-post (*after* transaction) asymmetric information; the risk that one party to a transaction will engage undesirable behavior (from the other party's point of view)
- ***principal-agent problem*** – managers act in their interest, not in owners' interest (incentives problem)
- ***conflict of interest*** – type of moral hazard problem caused by economies of scope; organization is involved in multiple objectives and has conflicts between those objectives (one corrupts the other)
- ***economies of scope*** – ability to use one resource to provide many different products and services

<u>Financial Structure</u>

1. stocks not the primary source of business financing
2. debt & equity securities not the primary source of business financing
3. indirect financing of businesses > direct financing of businesses (many times >)
4. financial intermediaries the primary source of business financing
5. financial system among most regulated sectors
6. only large corporations have easy access to securities
7. most debt contracts involve collateral
8. debt contracts complicated & regulate behavior



<u>Principles</u>

- Financial intermediaries lower transaction costs.
  - o take advantage of economies of scale
  - o develop expertise to lower costs
- Transaction costs lead to less transactions.
  - o Stock market: Transaction costs means less investment and less diversification.
- Moral hazard
  - o Equity: Managers have an incentive for fancy offices or embezzling money, not making a profit.
  - o Debt: Borrowers have incentives to take on projects that are riskier than the lenders would like.

<u>Avoiding adverse selection</u>

- private investors research companies
- government requires audits & disclosures
- financial intermediaries use expertise
- collateral & net worth mitigate default

<u>Avoiding moral hazard in debt contracts</u>

- collateral & net worth align incentives
- monitoring and restrictive covenants
  - o discourage undesirable behavior
  - o encourage desirable behavior
  - o keep collateral valuable
- financial intermediaries use expertise

<u>Avoiding moral hazard in equity contracts</u>

- investors audit firms
- government: audits & penalties for fraud
- venture capital firms in management
- use debt contracts instead

<u>Conflict of interest examples</u>

- investment banks: underwriting & research
  - o research optimistic for IPO issuers
- accounting firms: auditing & consulting
  - o opinions skewed, future consulting
  - o opinions audit consultants' systems
- credit rating agencies: rating & consulting