

The impact of asymmetric information and adverse selection finance essay



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Nowadays financial intermediations play the important role in the economy. Firms and individuals can find sources to finance its new project. Also lender can invest their money in secure positions. Financial intermediations raise funds from the depositors for short term and lend them to the borrower for long term. The main job of those institutions is to provide finance through taking extra risk. So there are three parties engaged in those investments process. The lender or the depositor could lend his money on secure way and low cost. The borrower can find the finance of his project. The financial intermediation manages the process of those transactions. The question now is that why do lender and borrower need financial intermediation to manage this relationship. Why do not they do it directly without a third party? The answer of this question needs to know the main reasons why financial intermediations exist. There are three reasons explain this issue. First reason is that, the different requirement of those two parties. Second reason is the transaction cost. Finally is the asymmetric information. In this essay we will focus on the asymmetric information as a reason of the existence of the financial intermediation. Also, in this essay I will first explain the Asymmetric information, adverse selection and moral hazard. Then I will brief some empirical study about the issue of the effect of Asymmetric information to represent the importance of this issue. Also, I will explain the effect of the transaction cost because it has relation with the information cost to avoid unobserved information. Finally, I will explain the financial intermediary natural and their role in guiding the financial process. My conclusion refers to the importance of financial institutions to avoid asymmetric information. I am also touched upon the difference between the risk transferring and risk sharing and the fails of those conventional institutions in the last financial

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crisis. I recommended Islamic industry is an alternative to those conventional ones which can be able to withstand during the crisis because they work as a partner with their consumer and they share the risks with them.

The impact of Asymmetric information, adverse selection, and moral hazard on the lender.

It is important to the lender to have the good quality and quantity information about the borrower to be in the safe side. When the information is poor that means there will be risk exist. Asymmetric information is an important concept in finance and needs to be understood. It means said Bucle (1998); the information refers to the situation where one party has more information than the other party. This is a problem with most types of transactions, financial or non financial transactions. In the

Case of a financial transaction, the borrower will have more information about the

Risks and return of the investment project for which funds are being borrowed and the lender do not have the same information the borrower does. So it may lead to actual conflict. Asymmetric information more affect lender, before he gives loan to the borrower and after.

Adverse selection is the result of asymmetric information which means a bad selection with high risk of default. The adverse selection refers to the borrower with adverse return.

Also, the second result of asymmetric information is moral hazard continued

Bucle (1998). The lender will face this particular problems, in which always

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happened after lending. This problem is described as bad behaviour that occurs when the lender takes the money from the lender and because the money is not belonged to him he will use it badly. He will use it for risky activities. As a result the lender will be at risk of losing his money.

Karlan and al (2005): investigate the moral hazard and adverse selection in credit market in South Africa. The random sample of 58000, of male and female, direct offers mail used by a larger lender in South Africa by three classes. First, offer interest rate. Second, contract interest rate which is equal or less the offer interest rate and revealed to more than 4000 borrowers that agreed to the first offer rate. Finally, a dynamic repayment with a good price on future loans for borrowers still in a good positions. These three stages supported by full information given to the lenders. The study setup distinguishes adverse selection from moral hazard impact on repayment. The result found that approximately 20% of default is because asymmetric information problems.

Another empirical study of the impact of asymmetric information conducted by

Gaul and al (2008) investigate the effect of unobservable information on corporate loan market, and if the borrower gives the lender the incentive to reduce the asymmetric information effects. The study used a regression to give evidence of a positive relationship between some measure of loan borrower by lender, contract terms, negotiating loans, and the amount of non- publicly information. The study found that, moral hazard and adverse selection problems do exist in the corporate loan market.

As a result of asymmetric information, adverse selection, and moral hazard is the transaction cost. So what do we mean by transaction cost? Bucle (1998) counts four types of transaction costs which are as follows. Firstly, search cost, the borrower and the lender will be affected by high cost of searching for accurate information about each other to avoid risks associated to default and loss money. Also, verification costs, which mean the cost that accrues when lender tries, ensure that information he has is true. Furthermore, monitoring costs, the lender after given loan to the borrower should follow the borrower activities to make sure he will be able to make payment as agreed. Finally, enforcement costs, in case of default the lender wants to ensure that the lender can be enforced to get the money back.

The importance of the financial intermediaries

The financial intermediation is the entity which in a med position between two parties and manage the financial transaction between them. Commercial banks, investment banks, stock investing services, insurance providers, etc are examples of the financial intermediation. So we can imagine the importance of those entities. For example banks, it does the important role. Banks obtain funds from depositors and then lend those funds to borrowers. Also provide financial services said Fraser and et al (2001). Also individual as lender can get fixed income at cheaper cost. Also, when the lender uses the financial intermediary he won't need to bear those costs. He does not have to spend money and time for collecting information to find good borrower. Moreover, he can get his money back at any time he want it. Also he does not have to bear risks of default the borrower and other risks because the risks are borne by the bank. Always banks have information and policy

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system about their clients and diversify their investment in case mismatching the maturities of their assets and liabilities said Saunders (2008).

Saunders and et al (2008) said 'because of costs of monitoring, liquidity, and price risk, as well as for some other reasons, savers often prefer to hold the financial claims issued by FIs rather than those issued by corporations'.

Diamond (1984) developed a model of delegate monitoring. Financial intermediary acts as monitor by promising the lender a fixed income and monitor the borrower activity to fulfil the lender the promise said Allen et al (2008). Another model developed by Boot and Thakor (1997) about delegated monitoring. They assume that, there are three kind of information. First, incomplete and unclear information about the future activity that the borrower is going to do and they suggest the solution is using financial market to obtain this information. Second the lender does not have information about the lender activity in term of invest the money in safe or risky project, and they suggest the solution by intermediary. Finally, borrower might have the chance to invest in a risky project and also they suggest the solution by intermediary said Allen et al (2008).

Conclusion and recommendations:

In conclusion, financial intermediaries do not exist by chance the economy has found them. As it shows above it exist because the need of the two separate parties and these parties represent the structure of the economy in any country. Borrower wants to have finance in his new project. Also lender need to be safe from asymmetric information, adverse selection of borrower

and moral hazard and it is the financial intermediary's main job. To collect information about the borrower is not an easy task. It contains high cost for the small lenders which prevents him to invest his money. Also, he cannot give his money to the wrong person or firm. Financial intermediary could do this job on behalf of the investor. This job can be done by financial intermediaries in a low cost because of the large number of the customer they deal with. Also they act as specialist to this kind of financial transactions.

However, financial intermediary is not always the haven. It has also risks of default, credit risk, liquidity risk, and etc. As we experience in the last financial crisis and the collapse of the biggest financial institutions around the world as a result of transferring risk. I think Islamic banks are the solution. They share risks instead of transfer them. Every party have to bear part of the risk to be able to continue. Transferring risks are not the solution, which means party will have nothing and other will have everything as a result part of the economy, will continue and the other part will collapse. Let's imagine the collapse party is the banks. So, the crisis will extend to the economy as a whole.