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ASYMMETRIES IN THE RELATIONSHIP BETWEEN ENTERPRISES AND FINANCIAL INSTITUTIONS

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The phenomenon of information asymmetry in cooperation between firms and financial institutions

The mismatch of information between the various parties involved in the financial markets can be termed as information asymmetry. Information asymmetry mostly occurs when the agents in a market do not have adequate or accurate information about a transaction they wish to undertake. This leads to risk taking when engaging with other parties and is not a good practice. An investor in the financial markets may wish to buy certain securities at a time when the market is experiencing troubles or when there is a herding effect and due to little information about the value of the securities and current market trends, he ends up borrowing a loan to finance the investment. This can be risky both to the lender and the borrower, in this case the investor since the investments may not yield desired profit.[1]

The phenomenon can be easily likened to small firms and big corporations. Information asymmetry between the firms and the bankers for instance is very dangerous. The financial institutions rely on firms to do business but they might not maximize their profits when they depend on loans to individuals alone. Therefore for financial to do business well with firms, adequate information has to be obtained on how they are growing, liquidity, their level of credit risks and many other indicators of company well being.[2] Such informa-

[1] P.M. Healy, K.G Palepu: *Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature*, "Journal of Accounting and Economics" 2001, Vol. 31, Iss. 1–3, pp. 405–440.

[2] R.N. Bebczuk: *Asymmetric Information in Financial Markets: Introduction and Applications*, Cambridge University Press, Cambridge 2003, pp. 132–135.

tion is however very had to obtain and requires other means and financial investments in order to access such information.

Lack of important information also on the part of the financial institutions makes them less attractive in the market. Financial institutions may be willing to invest in real estate and facilitate mortgages, but due to information asymmetries between construction firms and the financiers, proper decision making cannot be made. This leads to high cost of financing in order to cover on the risks in the mortgage industry.

Lenders are the most affected segment of financial institutions by information asymmetries. When the banks or a mortgage company wants to lend or finance a project, they must understand the type of client they are dealing with.[3] The borrower or the firm may be having certain qualities that make the firm a risky borrower. If the firm is tied in other obligations touching on financial aspects, the bank may have to change the terms of the contract such that it will not be affected by such obligations. It will be fine if the bank is able to obtain such information, but in some cases, such information is hard to obtain and the bank might incur a lot of losses if other external factors makes it hard to enforce the contract. Such problems can best be dealt with if information about the borrower is available to the lender.[4]

The relationships between firms and financial institutions are also evident in situations where one party has valuable information than the other party in the transaction. A borrower may hide information that could have landed him higher interest rate on the loan. Similarly, lenders may be having important information that they can use against the borrower such that the borrower cannot change banking relationship since it will be expensive and takes time to achieve trust with other financial institutions. Relationships between the financial institutions and firms help to minimize costs but due to information held by banks and other intermediaries, they are able to take advantage of the information and profit from it without borrowers' knowledge.[5]

Nevertheless, information asymmetry is generally bad for both parties in any transaction because it makes it hard to understand the other party's position before a contract is entered. This is referred to adverse selection, which leads to imbalance of power and the party with better information will tend to benefit at the expense of the other party with little information. This in relationship banking for instance affects the relationship negatively. It therefore can be seen that financial institutions try to minimize adverse selection through various services they offer.[6]

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[3] R. Duchin, O. Ozbas, B.A. Sensoy: *Costly external finance, corporate investment, and the subprime mortgage credit crisis*, "Journal of Financial Economics" 2010, Vol. 97, Iss. 3, pp. 418–435.

[4] R.N. Bebczuk: *Asymmetric Information in Financial Markets: Introduction and Applications*, Cambridge University Press, Cambridge 2003, pp. 77–84.

[5] E.L. von Thadden: A*symmetric information, bank lending and implicit contracts: the winner's curse*, "Finance Research Letters" 2004, Vol. 1, Iss. 1, pp. 11–23.

[6] T.S. Campbel, W.A. Kracaw: *Information Production, Market Signalling, and the Theory of Financial Intermediation*, "The Journal of Finance" 35/1980, pp. 863–882.

Moral hazard also hurts relationships and cooperation between firms and financial institutions after a transaction. The problem lies on the firms in most instances because businesses may change their behaviors after the contract or after getting financial support. This hurts the relationship since such problems could have been avoided if information was readily available to financial institution. This necessitates monitoring in order to bridge the information gap after the contract. Information monopoly and agency theory are some of the aspects heavily reliant on information and information asymmetry will adversely affect the relationship between the two parties.[7]

The importance of the rules designating the asymmetrical relationship between the company and financial institutions

Asymmetric relationship in the context of finance and economics is a situation where two parties in a transaction do not have equal opportunity or power. The inequality arises due to information imbalance between the two [parties to a contract or a transaction, such that one of the party, say a seller has better information (may be on quality) than the buyer. This creates a problem like what is seen in the case of lemons in the US.

The problems associated with such relationship is evident in the financial markets where the financial institutions possess high quality information about their clients or the market as a whole and further uses the information to their advantage and to the detriment of firms who transact with the financial institutions. Firms on the other hand may withhold information about their weaknesses or their true intentions prior to a contract such that in the long run, the relationship favors the firms over the financial institutions. Such relationships in essence, were meant to help build both parties and there is always the need to put in place the necessary frameworks that will point out asymmetries in the relationship.

The frameworks and rules specifying the asymmetric engagements between firms and financial institutions is important to the extent that too much power vested in one party will make the relationship less productive in the long run. To make the financial markets more attractive and competitive, there need to be enough freedom and information flow between the firms and the financial institutions so that asymmetric relationship does not occur. This requires rules to be put in place such that asymmetric relationships can be identified and dealt with in the right manner. Putting in place rules guiding the divulgence of specific information helps to safeguard both the financial institutions and the firms. The availability of information to both the parties makes the whole financial system competitive and minimizes absolute power possessed by a party. Therefore, the existence of credible regulations that set out guidelines for disclosure and protection of sensitive information will help both firms and financial institution to have mutual respect towards one another further promoting healthy competition.

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[7] R.N. Bebczuk: *Asymmetric Information in Financial Markets: Introduction and Applications*, Cambridge University Press, Cambridge 2003, pp. 145–153.

The rules are also important in ensuring stability in the financial markets. Asymmetric relationship in financial markets may create huge imbalances and mismatch of demand and supply of financial services that will eventually kill the market if not corrected. Suppose financial institutions are overly powerful to the extent of controlling the entry of new financial institutions in the market. This will bring in oligopolistic market structures that will suppress growth and innovation in the financial markets. Cost of capital will rise in the case of lenders and rates of returns on investments will be lowered in the case of investment funds. This will reduce the vibrancy of the financial markets. The rules and regulations on asymmetric relationship will help minimize too much power especially on information such that financial institutions do not misuse their ability to access information.[8]

Information monopoly is another inherent problem in an asymmetric relationship between parties in the financial markets. It is also a bone of contention between authorities and the financial institutions on whether specific information can be obtained from clients or not. Information sensitivity on certain matters such as ownership, company creditors and other agreements that are not party to current contracts and transactions are becoming serious issue. This is because the financial institutions mostly would want their clients to divulge more information about its commitments elsewhere, even to an extent of obtaining company secrets. This gives the financial institutions the power to influence transactions outcome, and that is asymmetric relationship. When rules exists that specify what information can create an asymmetric relationship, the problems caused by information monopoly are eliminated or minimized to manageable levels.[9]

Identifying asymmetric relationship between the financial institutions and firms is a hard task because of the nature of the relationship the two parties have cultivated over time. Having specific guidelines and rules that defines asymmetric relationship in financial markets will serve to allay misconceptions and wrong application of asymmetrical relationships. Banks for instance uses information about its clients to gain more advantage and influence during a negotiation but will still claim it has a healthy cooperation with its customers. In such situations, rules become important in clearly differentiating the extent to which a relationship can be deemed asymmetrical.

The rules also protect the interest of the parties and ensure non exploitation of parties during financial transactions. Mortgage financing for instance can be priced highly by mortgage companies while they clearly know there is over-investment in the real estate. Laws can be used to prevent arbitrary use of such information secretly by financial intermediaries to make gains out of unsuspecting buyers in an asymmetric relationship with mortgage bank.

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[8] S.C. Myers: *The Capital Structure Puzzle*, "The Journal of Finance" 39/1984, pp. 574–592.

[9] J. Houston, C. James: *Bank Information Monopolies and the Mix of Private and Public Debt Claims*, "The Journal of Finance" 51/1996, pp. 1863–1889.

The objectives of financial institutions in the development of asymmetric information to businesses

Financial institutions in most instances would wish to have more power that their clients in the transaction or in a given contract. It is also common during negotiations that parties engaged uses various ways to gain an advantage over the other in determining and influencing the outcome of the negotiation. The financial institutions similarly have different objectives in developing loopholes for asymmetric relationship with their clients or other institutions. The asymmetry is also further developed such that the skewed relationship is geared towards their favor. In some situations, the asymmetric relationship may be beneficial to both parties but in most instances, it favors the financial institutions and not both the firms and financial institutions.

One of the objectives that are beneficial to both parties in the transaction is the risk management aspects of asymmetric cooperation. The financial institutions in the activities undergo a lot of challenges in managing risks which are largely information based. To obtain relevant and accurate information on both systemic and un-systemic risks, the financial institutions have to seek information from the market and from its clients. This gives the financial institutions more power over the clients in the process resulting to asymmetric relationship. This factor is inevitable for investment banks and more so the lending institutions.[10] Creditworthiness is one element that forces financial institutions to employ tactics that ends up being viewed as asymmetric relations so that they can obtain valuable information.

The risk element in this case also serves to enhance other objectives for developing asymmetric relationships in the financial markets. Since financial institutions face the risk of losses due to their nature of work and position in the market, they have to compensate themselves for taking such huge risks. Insurance firms for instance do not give all the freedom in their contract construction with the client since in the event of a loss, various ways can be used to seek indemnity and compensation, which may not be warranted. This is one way financial institutions uses the asymmetric relationships to make a profit and pay themselves for taking serious risks on behalf of their clients.

Protecting the clients from loss is also another motivation for asymmetric relationship designed by financial institutions. For instance, giving the borrower an upper hand during a loan negotiation may lead to low cost of financing arrangements without knowing the underlying risks like moral hazard. The borrowing firm may eventually fail to service its loans and be forced to sell off assets that were not collateralized during the contract. Financial institutions, by using their highly developed techniques help to limit the freedom held by borrowers in making certain decisions since they have limited information about the market. It is therefore the interest and objective of the financial institutions to have more

[10] J.B. Heaton: *Managerial Optimism and Corporate Finance*, "Financial Management" 2002, Vol. 31, No. 2, pp. 33–45.

say and control over the transaction if they have to protect their clients from certain losses. Their objective is thus connected to protecting themselves from related expenses and work involving recovering the defaulted loans.[11]

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Summary

Financial institutions are operating in a very competitive environment under which financial institution is built. Both within the financial markets and the global economy is very competitive and without elaborate means of customer retention techniques and strategic planning, financial institutions risk being edged out by superior corporations. Although they play important roles, individual institutions have to gain control of their markets. This is achieved by creating asymmetries in their relationship with clients. Asymmetric relationship gives financial institutions the power to make

[11] S.A. Sharpe: *Asymmetric Information, Bank Lending, and Implicit Contracts: A Stylized Model of Customer Relationships*, "The Journal of Finance" 45/1990, pp. 1069–1087.

decisions that reflects future profitability. Using lock-in costs on its clients ensures they have assured market for a longer time.

Financial institutions also create a way in which they can monopolize the information they have about the firm firms they are transacting with. To obtain information, they have to create a way in which they are superior to their clients. For instance, insurance firms can introduce a simpler way for firms to pay their premiums and in doing so they have controlled the way the company relates to it. This is a source of information that can be adjusted depending on the wishes of the insurance firm. This information can be used to ensure the company sticks to the insurance firm since it gives it flexible premium terms. The objective of the financial institution in holding such information is to create an imbalance in the market using the crucial information not known by competitors.

Most of the objectives of financial institutions in developing asymmetric relationship are centered on profitability and competitiveness in the financial markets which o some extent is good for both financial institutions and firms.

ASYMETRIE W RELACJACH POMIĘDZY PRZEDSIĘBIORSTWAMI I INSTYTUCJAMI FINANSOWYMI

Streszczenie

Instytucje finansowe działają w bardzo konkurencyjnym środowisku. Zarówno w na rynkach finansowych, jak i biorąc pod uwagę gospodarkę globalną, można podkreślić wysoki poziom konkurencyjności. Można przypuszczać, że bez zaangażowania skomplikowanych narzędzi oraz technik utrzymania klienta i planowania strategicznego, instytucjom finansowym mogłoby grozić wyparcie przez globalne korporacje. Mimo że odgrywają ważną rolę, poszczególne instytucje są zaangażowane w przejmowanie kontroli na poszczególnych rynkach. Osiąga się to poprzez tworzenie asymetrii w relacjach z klientami. Niesymetryczny stosunek instytucji finansowych daje uprawnienia do podejmowania decyzji, odzwierciedlając poziom planowanej rentowności.

Instytucje finansowe również tworzą metody, jakimi mogą monopolizować posiadane informacje o przedsiębiorstwach z którymi współpracują. Na przykład, instytucje ubezpieczeniowe mogą wprowadzić prostsze sposoby rozliczeń dla przedsiębiorstw, a przez wprowadzać kontrolę wpływu zmian na relacje pomiędzy podmiotami, co może być wykorzystywane w podnoszeniu konkurencyjności instytucji ubezpieczeniowej na rynku.

Wydaje się, że znacząca część celów instytucji finansowych w rozwój asymetrycznych relacji skupia się na rentowności i konkurencyjności na rynkach finansowych, które w pewnym stopniu stanowi pozytywne rozwiązanie zarówno dla instytucji finansowych, jak i przedsiębiorstw.