

# Asymmetry in the Relationship between Enterprises and Financial Institutions

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**Abstract:** The asymmetry of information is a phenomenon of many business entities. It is also an important element of the relationship between the company and the financial institution. The aim of the paper is to draw attention to the asymmetrical relationship of entities in the context of a relationship where both parties do not have equal opportunities and power. The resulting inequality is the result of an imbalance between the two parties to the contract or transaction, creating a basis for achieving the advantage of one party and consequently the possibility to generate a positive result on one side only.

**Keywords:** the asymmetry of information, the relationship between a company and a financial institution

## Introduction

Information is fast becoming a very expensive item in the 21<sup>st</sup> century. Since the world emerged from the industrial age to the information age, it is becoming very necessary to have the right information at the right time. This has also been the case of global businesses where information is becoming a commodity that can be traded for a profit. Regarding financial markets and services relating to industry, information is highly valued and access to out-dated or wrong information leads to massive losses. These losses are mostly due to the mismatch of information availability and decision making processes. Financial institutions need to have accurate information when they are making any decision and without adequate and reliable information, they are bound to make risky decisions that in most cases leads to losses.

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

The mismatch of information between various parties involved in 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 (Jajuga, Jajuga 1998, pp. 88–89). This leads to risk taking when engaging with

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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/she ends up taking out 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 the desired profit.

The phenomenon can be easily likened to small firms and big corporations. Information asymmetry between firms and bankers for instance is very dangerous. 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 institutions 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 a company's well-being (Modigliani, Miller 1958, p. 3). Such information is however very hard 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 financiers, proper decision making cannot be made. This leads to the high costs of financing in order to cover the risks in the mortgage industry.

Lenders are the most affected segment of financial institutions by information asymmetries. When banks or a mortgage company wants to lend or finance a project, they must understand the type of client they are dealing with. 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, a bank may have to change the terms of the contract so that it will not be affected by such obligations. It will be fine if a bank is able to obtain such information, but in some cases, such information is hard to obtain and a 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 (Ricardo 2003, p. 18).

The relationships between firms and financial institutions are also evident in situations where one party has more valuable information than the other party in the transaction. A borrower may hide information that could have landed him/her higher interest rate on the loan. Similarly, lenders may have important information that they can use against the borrower such that the borrower cannot change the 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 the information held by banks and other intermediaries, they are able to take advantage of the information and profit from it without borrowers' knowledge.

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 as adverse selection, which leads to an 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 the various services that they offer.

Moral dangers also hurt 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 behaviours 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 the financial institution. This necessitates monitoring in order to bridge the information gap after the contract. Information monopoly and the agency theory are some of the aspects heavily reliant on information and information asymmetry and thus will adversely affect the relationship between the two parties.

## **2. The importance of the rules designating the asymmetrical relationship between a 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 the information imbalance between the two parties to a contract or a transaction, such that one of the parties, say a seller has better information (may be on quality) than the buyer.

The problems associated with such a 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 favours 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 (Jensen, Meckling 1976, pp. 305–339).

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 needs to be enough freedom and information flow between the firms and the financial institutions so that an 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 parties makes the whole financial system competitive and thus minimizes the absolute power possessed by a party. Therefore, the existence of credible

regulations that set out guidelines for disclosure and the protection of sensitive information will help both firms and financial institutions to have mutual respect towards one another and so further promoting healthy competition.

The rules are also important in ensuring stability in financial markets. Asymmetric relationships in financial markets may create huge imbalances and a mismatch of demand and supply of financial services that will eventually kill the market if not corrected. Suppose that 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. The 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 (Ross 1977, pp. 675–692). This will reduce the vibrancy of the financial markets. The rules and regulations on asymmetric relationship will help minimize too much power especially on the information such that financial institutions do not misuse their ability to access information.

Information monopoly is another inherent problem in an asymmetric relationship between parties in financial markets. It is also a bone of contention between authorities and 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 a serious issue. This is because the financial institutions mostly would want their clients to divulge more information about its commitments elsewhere, even to the extent of obtaining company secrets. This gives financial institutions the power to influence transaction outcomes, and that is an asymmetric relationship. When rules exist that specify what information can create an asymmetric relationship, the problems caused by an information monopoly are eliminated or minimized to manageable levels.

Identifying asymmetric relationships between 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 define asymmetric relationships in financial markets will serve to allay misconceptions and the wrong application of asymmetrical relationships. Banks for instance use information about its clients to gain more advantages and influence during a negotiation but will still claim it has 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 the non-exploitation of parties during financial transactions. Mortgage financing for instance can be priced highly by mortgage companies while they clearly know that there is over-investment in the real estate. Laws can be used to prevent the arbitrary use of such information secretly by financial intermediaries to make gains out of unsuspecting buyers in an asymmetric relationship with a mortgage bank.

### **3. The objectives of financial institutions in the development of asymmetric information to businesses**

Financial institutions in most instances would wish to have more power than their clients in the transaction or in a given contract. It is also common during negotiations that parties engaged use various ways to gain an advantage over the other in determining and influencing the outcome of the negotiation. Financial institutions similarly have different objectives in developing loopholes for asymmetric relationships with their clients or other institutions. The asymmetry is also further developed such that the skewed relationship is geared towards their favour. In some situations, the asymmetric relationship may be beneficial to both parties but in most instances, it favours 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, financial institutions have to find out information from the market and from its clients. This gives financial institutions more power over clients in the process resulting in asymmetric relationships. This factor is inevitable for investment banks and more so with lending institutions. Creditworthiness is one element that forces financial institutions to employ tactics that end up being viewed as asymmetric relationships so that they can obtain valuable information.

The risk element in this case also serves to enhance other objectives for developing asymmetric relationships in 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 clients 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 use asymmetric relationships to make a profit and pay themselves for taking serious risks on behalf of their clients.

Protecting 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 the low cost of financing arrangements without knowing the underlying risks like moral danger. 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 in the interest and an objective of financial institutions to have more 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.

Financial institutions are operating in a very competitive environment under which financial institutions are built. Both within financial markets and the global economy it is very competitive and without any 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 relationships with clients. Asymmetric relationships give financial institutions the power to make decisions that reflect future profitability. Using lock-in costs on its clients ensures they have assured the market for a longer time.

Financial institutions also create the 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 a 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 relationships are centered on profitability and competitiveness in financial markets which to some extent is good for both financial institutions and firms.

## Concluding remarks

Depending on the type of cooperation the firm has with financial institutions, access to important information can be easy. Those firms with close relationships with their bankers, investment bankers and brokers are in a better position to provide a financial institution with information that is relevant for bankruptcy analysis and monitoring. Financial institutions with longer term and a wider scope of relationships with their clients/firms can access all the necessary information much easier compared with financial institutions that have less close relationships with their clients.

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#### **ASYMETRIA W RELACJACH MIĘDZY PRZEDSIĘBIORSTWAMI I INSTYTUCJAMI FINANSOWYMI**

**Streszczenie:** Asymetria informacji jest zjawiskiem dotyczącym działalności wielu podmiotów. Jest również ważnym elementem relacji pomiędzy przedsiębiorstwem i instytucją finansową. Celem autora jest zwrócenie uwagi na asymetryczne relacje podmiotów, w kontekście relacji, której obie strony w nie mają równych szans i mocy. Powstająca nierówność jest wynikiem braku równowagi pomiędzy dwoma stronami umowy lub transakcji, tworząc podstawę do osiągnięcia przewagi jednej ze stron, a w konsekwencji możliwość wygenerowania pozytywnego rezultatu tylko po jednej stronie.

**Słowa kluczowe:** asymetria informacji, relacja instytucja finansowa–przedsiębiorstwo

#### **Cytation**

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