asymmetric information

- If not all parties in a financial transaction will have access to the same amount of information - information asymmetry exists
  - A change in consumers' preferences might mean that borrowers face a more challenging market than they expected and might have difficulties keeping up with their bond payments.
  - When transactions are made, no party can fully anticipate what is going to happen in the future even if both has the same information and made an informed decision.
  - Borrowers might have private information that the public is not aware of
    - For example, an upcoming lawsuit, expected unfavorable conditions - this is information asymmetry, when one party has more information than the other.
  - Information asymmetry makes it costly for savers and borrowers to make exchanges in the financial market

- Risk diversification
- Maturity transformation
- Reduction of information asymmetry - related to information costs
  - Adverse selection
    - Occurs before a transaction
    - Targeted at riskiest individuals
    - Eg. Car dealers and insurance companies
    - Example: stock market
    - Lenders problem with distinguishing good borrowers from the bad before making an investment
    - For example in the stock market, investors have to decide which firm they want to invest in. if there are two tech companies that produce similar goods, but one has superior products to the other. The investors will not have knowledge about te qulity of the goods and so would value the stock of both firms equally. Investors cannot determine the value of productive capabilities and scientific expertise. The shares of the company will b undervalued and the cost of capital would be higher than if investors had all the information. Thus, there is a cost to both the investor and the company which reduces market efficiency and intermediates intervene to fill this gap.
    - This applies to the bond market as well. If the interest rates