
UNIVERSITY OF THE PEOPLE

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Learning Journal Unit 3

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Chapter 8 explores the sources of external finance for companies, including bank loans, bonds, stock offerings, and trade credit. Loans from banks and other financial institutions, rather than securities markets, provide the majority of external funds. This predominance of loan financing over securities issues is explained by three concepts - transaction costs, asymmetric information, and the free rider problem. "Most such financing, however, ultimately comes from loans, bonds, or stock. In other words, businesses that extend trade credit act, in a sense, as nonbank intermediaries, channeling equity, bonds, and loans to small companies." (Wright & Quadrini, 2009).

Transaction costs like brokerage fees and liquidity reductions mean individuals struggle to invest profitably on a small scale. Financial intermediaries achieve minimum efficient scale in issuing loans and overcome other barriers like search and information costs. They also develop expertise at acquiring and processing vital information. Expenses incurred during the exchange of goods and services or products are known as transaction costs (Downey, 2023). It could instead be seen as the work necessary to deliver a product to customers, leading to the establishment of a whole company dedicated to enabling transactions (Downey, 2023).

Asymmetric information refers to a situational advantage where one party possesses superior data. This manifests in three issues that intermediaries are better equipped than dispersed markets to mitigate - adverse selection, moral hazard, and principal-agent (agency) problems. Adverse selection occurs before contracting, when hidden information about risk leads to adverse outcomes like loan default. Moral hazard describes post-contractual incentives for borrowers and insured entities to act against the interests of the other party. Agency problems arise when agents (employees) do not fully represent the interests of principals (owners).

Screening loan applicants, monitoring borrower behavior, aligning stakeholder incentives, and other mechanisms reduce such information issues. But individuals face high costs directly acquiring and symmetrically disseminating information. Hence intermediaries, with scale economies and proprietary data, prevail.

Government policies aim to bolster transparency and oversight. But some regulations impose controversy and unintended consequences. Technology continues to lower information costs. Peer-to-peer lending promises new models while still facing inherent information hurdles. Overall, intermediaries endure by offsetting persistent information asymmetries.

Reference:

Wright, R.E. & Quadrini, V. (2009). Money and Banking. Saylor Foundation.

Downey, L. (2023, March 26). What are transaction costs? definition, how they work, and example. Investopedia. <https://www.investopedia.com/terms/t/transactioncosts.asp>

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