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### Essays on Corporate Finance and Financial Intermediation

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## SUMMARY

In this dissertation we have explored an important and long-standing issue in finance research, namely: *how do corporations finance themselves, and in particular, how is this driven by the specific roles of different types of capital suppliers in the financial market?* We presented four theoretical essays on the interface of corporate finance and financial intermediation, which addressed this question from both a demand and a supply perspective. Our analysis in these essays built on concepts of information economics, and specifically game theory. In the first two essays (Chapter 2 and Chapter 3) we analyzed the main determinants of a firm's choice of contract type and funding source. In the third and the fourth essay (Chapter 4 and Chapter 5) we focused on the optimal organization and structure of financial intermediaries and the financial sector in an economy. Below we will briefly summarize the main insights, contributions and implications of our analysis.

In **Chapter 2** ('Information Asymmetry in Financial Markets: Implications for Financial Contracting and the Firm's Funding Source Choice') we reviewed the key insights developed in the modern corporate finance and financial intermediation literature, which analyzes the consequences of the existence of asymmetric information between firms and financiers for a firm's investment and financing decisions and for the functioning of financial markets. We designed a simple, *uniform* model structure in order to illustrate the investment distortions that may arise due to informational problems and their potential solutions. We presented solutions in two dimensions: the firm's choice of financial contract and the firm's funding source choice. We consequently linked the proposed solutions to informational problems to specific firm characteristics, and derived conclusions with respect to the main determinants of a (borrowing) firm's financing choice. Our main findings are summarized in the *Tables 1 through 4* in Chapter 2. Our analysis pointed at the potential existence of certain frictions in the funding of specific types of firms. In particular, we argued that small, new and information-problematic firms with highly specific (or intangible) assets may face significant problems in obtaining external financing, and thus are subject to underinvestment problems and market failure.

In **Chapter 3** ('Discretion in Bank Contracts and the Firm's Funding Source Choice between Bank and Financial Market Financing') we provided a rationale for the use of flexibility and discretion in bank contracts. The basic idea that we developed in this chapter is that discretionary contracts allow banks which produce information on borrowers to optimally condition (or 'fine-tune') the contract terms of their loans on non-

verifiable (and thus non-contractible) information obtained from monitoring. This argument is in line with the important ongoing discussion in economic theory on rules versus discretion, where discretion allows for more informative decision-making based on more subtle - potentially non-contractible - information. An optimal information flow is crucial for sustaining discretionary contracts. Since higher quality banks can be expected to receive better information from monitoring than lower quality banks, the benefits of discretion will depend on the expected quality or reputation of the bank. We designed a model structure in order to formalize this intuition and analyzed a borrowing firm's investment and funding source decisions in this context. We showed that better quality borrowers prefer discretionary contracts offered by higher quality banks. Lower quality borrowers have no option other than to mimic the high quality borrower's contract choice in a pooling equilibrium. Our analysis has implications for a borrower's funding source choice and his choice of investment projects. We showed that discretion in bank contracts may enhance both ex ante and ex post investment efficiency on the side of the borrower. This suggests a link between the type of a firm's investment projects and its financing choices. We also emphasized a link between the quality of the banking system, the level of information production by banks and the types of contracts offered in an economy, and - more importantly - the competitive position of banks vis-à-vis financial markets. In particular, we have shown that the use of discretionary bank contracts increases the market share of banks vis-à-vis financial markets for better quality borrowers in a competitive credit market. Finally, we argued that the benefits of long-term discretionary bank contracts cannot be mimicked through the use of short-term financing.

In **Chapter 4** ('Market Discipline and Incentive Problems in Conglomerate Banks') we analyzed the optimal conglomeration of bank activities. We focused on market discipline and internal incentives as key factors in determining the overall risk and decisions of financial institutions. In particular, we argued that internal incentives and also the effectiveness of market discipline differ dependent on whether divisions operate stand-alone or as part of a conglomerate. The argument that we developed in this chapter is that conglomeration results in less transparency and therefore reduces the effectiveness of market discipline. That is, the pooled funding cost of a conglomerate bank only partially reflects each bank division's risk choices. This may induce cross-subsidization and free-riding between divisions, since each division does not fully internalize the consequences of its own actions. On a positive note, the divisions in a conglomerate bank co-insure each other. This results in potential diversification benefits. We designed a model structure in

which we captured this tradeoff and identified two determinants of the optimal organizational structure of banks: the degree of market discipline (or transparency) that a bank division would be subject to if it operated stand-alone, and the degree of competition in the market in which the division operates. We showed that effective market discipline reduces the potential benefits of conglomeration. With ineffective market discipline of stand-alone activities conglomeration would further undermine market discipline, but may nevertheless be beneficial if the diversification benefits are sufficiently large. This is the case when competitive rents are low. A more competitive environment therefore may induce conglomeration. In an extension of our model we have shown that the benefits of conglomeration can be improved upon by an effectively designed internal cost of capital allocation mechanism. We furthermore argued that, due to precommitment problems, stand-alone divisions cannot mimic the optimality of conglomeration through the use of incentive contracts. We finally generalized our model in order to analyze the potential conflict between transaction- and relationship-oriented banking activities in modern banking. Here our focus was on the issue of the optimal organizational structure of proprietary trading activities in banks. In this context we showed that excess risk taking in proprietary trading activities may undermine relationship-specific activities and increase the cost of capital for a bank at large.

In **Chapter 5** ('Issues in Venture Capital Financing') finally we analyzed the market for venture capital as a financing source for entrepreneurial firms. We considered the institutional design of the venture capital market and reviewed the (scant) recent theoretical literature which analyzes the informational roles of venture capitalists as financial intermediaries and the distinct contractual features of venture capital arrangements. We designed a simple model structure in order to show that informational problems and/or frictions on the supply side of the market for venture capital may result in an undersupply of entrepreneurial activity in the economy, and thus may warrant government intervention. In this context we analyzed the impact of different measures of government intervention on an entrepreneur's incentives to exert innovative effort and on a capital supplier's incentives to produce information and to develop expertise in financing entrepreneurial firms. In the last part of the chapter we discussed and evaluated recent Dutch measures of government intervention aimed at stimulating the supply of risk capital in the context of our model. Our main conclusion is that public intervention in the capital market is most effective if it is accompanied by significant private sector involvement. This guarantees co-sharing of risk and also induces some market discipline.

