Lecture 18/19

Lecture 18/19 will use the following transparencies plus Figures 1 and 2 of Chapter 8 of the textbook
Puzzles of Financial Structure

1. Stocks are not most important source of finance for businesses

2. Issuing marketable securities not primary funding source for businesses

3. Indirect finance (financial intermediation) is far more important than direct finance

4. Banks are most important source of external finance
Puzzles of Financial Structure (contd.)

5. Financial system is among most heavily regulated sectors of economy

6. Only large, well established firms have access to securities markets

7. Collateral is prevalent feature of debt contracts

8. Debt contracts are typically extremely complicated legal documents with restrictive covenants
Transactions Costs and Financial Structure

Transactions costs hinder flow of funds to people with productive investment opportunities.

Financial intermediaries make profits by reducing transactions costs.

1. Take advantage of economies of scale
   *Example*: Mutual Funds

2. Develop expertise to lower transactions costs
   *Explains Puzzle 3*
Adverse Selection and Moral Hazard

Adverse Selection:
1. Before transaction occurs
2. Potential borrowers most likely to produce adverse outcomes are ones most likely to seek loans and be selected

Moral Hazard:
1. After transaction occurs
2. Hazard that borrower has incentives to engage in undesirable (immoral) activities making it more likely that won’t pay loan back
Adverse Selection and Financial Structure

Lemons Problem in Securities Markets

1. If can’t distinguish between good and bad securities, willing to pay only average of good and bad securities’ value.

2. Result: Good securities undervalued and firms won’t issue them; bad securities overvalued so too many issued.

3. Investors won’t want to buy bad securities, so market won’t function well.

*Explains Puzzle 2 and Puzzle 1.*

*Also explains Puzzle 6:* Less asymmetric information for well known firms, so smaller lemons problem
Tools to Help Solve Adverse Selection Problem

1. Private Production and Sale of Information
   Free-rider problem interferes with this solution

2. Government Regulation to Increase Information
   Explains Puzzle 5

3. Financial Intermediation
   A. Analogy to solution to lemons problem provided by used car dealers
   B. Avoid free-rider problem by making private loans
      Explains Puzzles 3 and 4

4. Collateral and Net Worth
   Explains Puzzle 7
Moral Hazard: Debt Vs. Equity

Moral Hazard in Equity: Principal-Agent Problem

1. Result of separation of ownership by stockholders (*principals*) from control by managers (*agents*)
2. Managers act in own rather than stockholders’ interest

Tools to Help Solve the Principal-Agent Problem

1. Monitoring: production of information
2. Government regulation to increase information
3. Financial intermediation
4. Debt contracts

*Explains Puzzle 1:* Why debt used more than equity
Moral Hazard and Debt Markets

Moral hazard: borrower wants to take on too much risk

Tools to Help Solve Moral Hazard
1. Net Worth
2. Monitoring and Enforcement of Restrictive Covenants
3. Financial Intermediation
   Banks and other intermediaries have special advantages in monitoring
   *Explains Puzzles 1–4.*