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Essays on Agency Costs in Financial Intermediation

Abstract of Dissertation

My dissertation studies the causes of conflicts of interest in financial intermediation and proposes solutions for alleviating them. My job market paper, “Lending Platforms’ Information Aggregation under Competition,” examines how lending platforms as financial intermediaries use their information advantage to deter adverse selection in their competition for creditworthy borrowers. Using data from peer-to-peer lending platforms and a platform entry event which exogenously induces platform competition for both borrowers and lenders, I find that the incumbent platform possesses an information advantage by incorporating information that cannot be leveraged by the entrant into borrower screening and loan pricing. I show that, with better knowledge about the borrowers’ quality, the incumbent platform attenuates its own adverse selection by aggressively undercutting loan prices for creditworthy borrowers. Lenders on the incumbent platform free ride on this information advantage. In addition, the incumbent exacerbates the entrant’s adverse selection by leaving it a greater number of risky borrowers. To compensate for this information disadvantage, lenders on the entrant platform demand higher ex ante loan prices.

The second chapter of my dissertation, “Investment Bank Governance and Client Relationships,” is coauthored with Professors William Wilhelm, Zhaohui Chen and Alan Morrison. We study how investment bank complexity, based on factors such as the scale of proprietary trading and the development of complex financial products, induces conflicts of interest and the breakdown of trust between investment banks and their clients, damaging the relational contract at the heart of investment banking relationships. Banks’ ability to commit to relational contracts with their clients depends on internal governance mechanisms that align the interest of individual bankers with the financial well-being of their clients. We argue that the increasing complexity in investment banks weakens their internal governance and subsequently upsets their relationships with the clients. We estimate the causal effect between increasing bank complexity and the likelihood of a relationship being broken.

In the third chapter, “Optimal Equity Financing Contracts and Private Monitoring,” I design a contracting mechanism to study how, in a typical principal-agent setting, a venture capitalist’s (the principal’s) private monitoring of the entrepreneur’s (an agent’s) effort exertion leads to higher effort from the agent and more efficient allocation of capital investments from the principal. The contract design extends the conventional “pay-for-performance” incentive by stipulating a punishment option which grants the entrepreneur a lower equity stake. It is incentive compatible for the venture capitalist to exercise the punishment only upon observing low effort, ensuring the optimal equilibrium path. I show that, compared with the “pay-for-performance” incentive scheme, monitoring lowers the incentive requirement to induce high effort, promising the venture capitalist a higher stipulated equity stake. Gaining higher marginal return on investments, the venture capitalist allocates the capital investments more efficiently, yielding a higher ex-ante project value.

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