FIN THEORY II (Part 2)

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FINANCIAL CONTRACTING

This course examines how moral hazard impairs firms’ ability to finance investments, and how firms and investors can mitigate the resulting inefficiencies through monitoring, collateral, corporate diversification, and the design of corporate securities. The course consists of two parts:

PART I: MORAL HAZARD AND PLEDGEABLE INCOME

Applying and extending the famous model by Holmstrom and Tirole (1997), we will learn how entrepreneurial moral hazard reduces the income firms can pledge to raise outside funding, and how this in turn leads to credit rationing and underinvestment in equilibrium. We will also learn how firms and investors can boost pledgeable income by setting up monitoring technologies, posting collateral, and through corporate diversification. With regard to corporate securities, we will learn how debt overhang can cause underinvestment, how debt dominates equity in situations of moral hazard, and how equity dominates debt when agents can risk-shift.


PART II: OPTIMAL FINANCIAL CONTRACTING UNDER MORAL HAZARD

While Part I considers the choice between debt and equity, Part II considers optimal security design in a more general setting. We will study three different settings, which differ in the degree to which cash flows are verifiable: in the Innes (1990) model, cash flows are fully verifiable; in the Townsend (1979) and Gale-Hellwig (1985) “costly-state verification” models, cash-flows are semi-verifiable; and in the Bolton-Scharfstein (1990) incomplete-contracting model, cash flows are non-verifiable.


