Helsingin yliopisto - Helsingfors universitet - University of Helsinki ID 2000-463

Tiedekunta-Fakultet-Faculty		Laitos-Institution-Department
Valtiotieteellinen tiedekunta		Department of Economics
Tekijä-Författare-Author		
Vauhkonen, Jukka		
Työn nimi-Arbetets titel-Title		
Adverse Selection and Costly Screening in Credit Markets		
Oppiaine-Läroämne-Subject		
Economics		
Työn laji-Arbetets art-Level	Aika-Datum-Month and year	Sivumäärä-Sidantal-Number of pages
Licentiate thesis	1999-03-01	68 s.

Tiivistelmä-Referat-Abstract

In this thesis we analyse the functioning of credit markets in environments where adverse selection interferes with an efficient allocation of capital. Throughout the thesis we assume that borrowers have private information on the profitability of their investment projects and, consequently, on the probability of being able to repay the funds they have loaned. A special feature of our thesis is that lenders can reduce or totally eliminate the adverse selection problem by expending resources on the ex-ante screening of borrowers. Thus, by investing in ex-ante screening lenders can reduce the informational gap between them and borrowers before the financial contract is signed.

In the first model we derive the optimal financial contracts between a monopoly lender and two types of borrowers in an environment where good borrowers' return distributions first-order stochastically dominate bad borrowers' return distributions and where the lender has access to a costly and perfect screening technology. When the lender can commit to stochastic screening; that is, when she can commit to inspect only a certain proportion of loan applicants, the unique optimal contract for bad borrowers combines features of equity and call option contracts. This results contradicts earlier studies, where in an otherwise identical environment but with a large number of small and identical lenders the optimal contract is the standard debt contract.

In our second model we investigate how the loan interest rate competition between two banks, only one of which has access to a costly but imperfect ex-ante monitoring technology, affects the optimal level of monitoring and, more generally, the feasibility of monitoring. We compare the investments in monitoring between a monopoly bank and a banking duopoly. We show that the state of economy is a crucial determinant of the effects of competition on the investment in monitoring: for low values of the state of economy, an increase in competition has no effects on monitoring incentives; for intermediate values of the state economy, competition reduces incentives to monitor; and for sufficiently high values of the state of economy, an increase in competition even increases investments in the monitoring technology. Furthermore, the intensity of competition between the two banks is shown to be an increasing function of the state of economy.

Avainsanat-Nyckelord-Keywords

adverse selection - credit markets

ex-ante screening - banking competition

Säilytyspaikka-Förvaringsställe-Where deposited

Muita tietoja-Övriga uppgifter-Additional information