This thesis consists of an introductory chapter and four essays on the financial contracting theory.

In the first essay, we argue that many adverse selection models of the standard one-period loan contracts are not robust to changes in the market structure. We argue that debt is not an optimal contract in these models, if there is only one (monopoly) financier instead of a large number of competitive financiers.

In the second essay, we examine the welfare effects of allowing banks to hold equity in their borrowing firms. According to the agency cost literature, banks’ equity stakes in their borrowing firms would seem to alleviate firms’ asset substitution moral hazard problem associated with debt financing. We argue that this alleged benefit of banks’ equity holding is small or non-existent when banks are explicitly modeled as active monitors and when firms have access also to market finance.

In the third essay, we extend the well-known incomplete contracting model of Aghion and Bolton to attempt to explain the empirical observation that the allocation of control rights between the entrepreneur and the venture capitalist is often contingent in the following way. If the indicator of the company’s performance (e.g., earnings before taxes and interest) is low, the venture capital firm obtains full control of the company. If company performance improves, the entrepreneur retains or obtains more control rights. If company performance is very good, the venture capitalist relinquishes most of his control rights.

The fourth essay is a short note, in which we show that main result of the model of Aghion and Bolton related to the optimality properties of contingent control allocations under incomplete contracting environment holds only if an additional condition is satisfied.

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