Equity allocation and risk-taking in the intermediation chain

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Overview

- Safe asset creation

- Trade-off:

    – Equity improves effort (and payoffs)

    – Equity is a buffer against losses

- High demand for safe asset

    – Tilts the outcome towards the latter
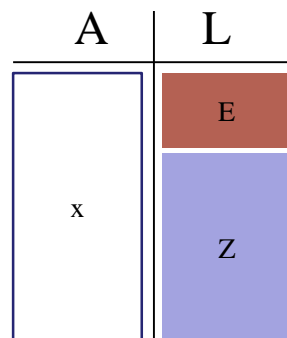
The basic environment

Originators

A	L
	E
x	Z
	D

Intermediaries

A	L
R_Z	E_I
R_Z	
R_Z	D_I

The basic environment

Let's simplify…

Originators

Intermediaries
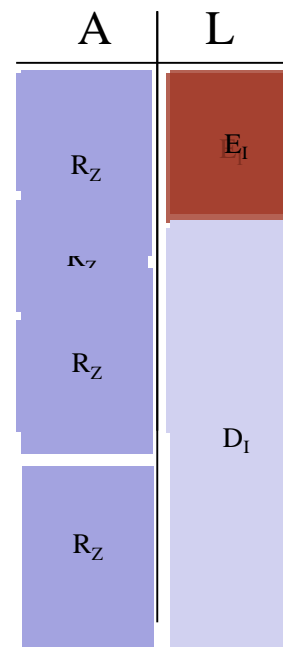
Incentives and safe assets

Originator 1

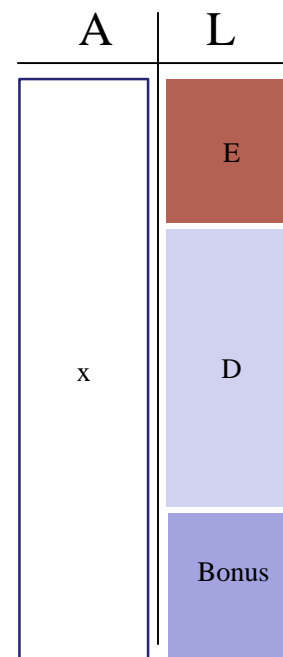|	L	H
L		(0,R)
H	(R,0)	(R,R)

Originator 2

- Safe asset production?

- Is equity an optimal contract?
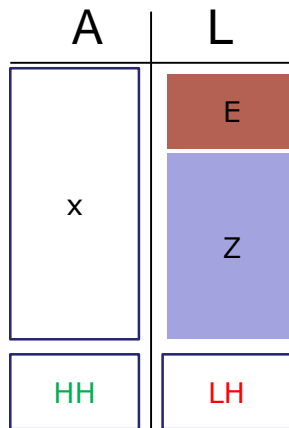
Separate ownership and control

- A Klopptimal contract

  - Hire the Origi-nator as a Mane-ger

  - Salah-ry contingent on aggregate outcome

  - 0 in case of failure

  - Bonus in high aggregate states

  - $E[\text{Bonus}|R] = c'(p^*)$

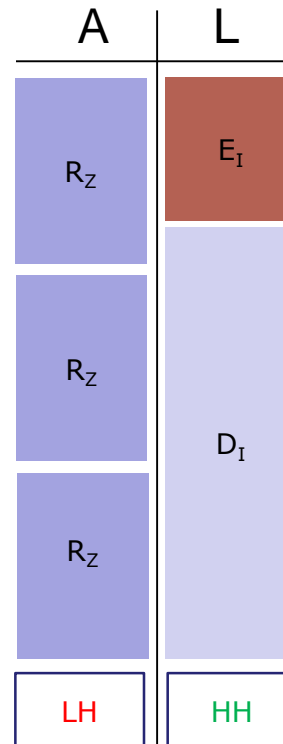 - Bonus 'pool interpretation

Holding Kompany

A	L
	E
x	D
	Bonus

Use derivatives

Originators

A | L

Intermediaries

A | L

Optimal contract and trade-off

- When does high demand for safe assets decrease effort?

	L	H
L		(0,R)
H	(R,0)	(R,R)

- Effort moves probability mass to good state

- Effort is costly

  – With equity, it is equally costly in all R states (LH and HH)

  – But the LH state price is > 1

  – Makes sense to decrease effort

- How does it play out under an optimal contract?

Thank you very much!