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Article

On the Positive Role of Financial Intermediation in Allocation of Venture Capital in a Market with Imperfect Information

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ABSTRACT

This paper develops a theory of financial intermediation that highlights the contribution of intermediaries as informed agents in a market with imperfect information. We consider a venture capital market where the entrepreneurs select the qualities of projects and their perquisite consumptions, about which the investors are imperfectly informed. It is shown that when all investors have positive search costs, the entrepreneurs are induced to offer the unacceptable inferior projects ("lemons" only), and the investors will not enter the venture capital market, but put their funds in other low return investments–an undesirable allocation of resources.

Beginning with an initial undesirable situation, the financial intermediaries may evolve as informed agents that induce a Pareto-preferred allocation, leading the investors to a higher welfare state. We focus our analysis on the existence of intermediation equilibra when the market for intermediation services is competitive. The distribution of returns on projects, the fees charged by intermediaries, and the fraction of institutional holdings are all endogenous in equilibrium. It is shown that (i) there cannot be a competitive intermediation equilibrium with very high institutional holdings, and (ii) in other cases multiple equilibra may exist, but the one with the highest institutional holdings dominates the others in a Pareto sense.

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