The Journal of Finance / Volume 38, Issue 5 / pp. 1543-1568

Article

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

YUK-SHEE CHAN

First published: December 1983

https://doi.org/10.1111/j.1540-6261.1983.tb03840.x

PDF

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.

REFERENCES

G.Benston. “Economies of Scale in Financial Institutions.” *Journal of Money, Credit and Banking* **4** (1972), 312–41.

Google Scholar

G.Benston and C.Smith. “A Transaction Cost Approach to the Theory of Financial Intermediation.” *Journal of Finance* **32** (1977), 215–32.

Google Scholar

T.Campbell and M.Kracaw. “Information Production, Market Signalling, and the Theory of Financial Intermediation.” *Journal of Finance* **35** (1980), 863–82.

Web of Science® | Google Scholar

T.Campbell and M.Kracaw. “Reply.” *Journal of Finance* **37** (1982), 1097–99.

Web of Science® | Google Scholar

Y.Chan. “Information Production, Market Signalling, and the Theory of Financial Intermediation: A Comment.” *Journal of Finance* **37** (1982), 1095–96.

Web of Science® | Google Scholar

Y.Chan and H.Leland. “Prices and Qualities in Markets with Costly Information.” *Review of Economic Studies* **49** (1982), 499–516.

Web of Science® | Google Scholar

Y.Chan and H.Leland. “Prices and Qualities in Markets with Imperfect Information: A Search Model.” manuscript, revised 1983.

Google Scholar

Web of Science® | Google Scholar

D.Diamond. “Essays on Information and Financial Intermediation.” Ph.D. dissertation: Yale University, 1980.

Google Scholar

D.Diamond. *“Financial Intermediation and Delegated Monitoring.”C.R.S.P.* Working Paper No. 82, University of Chicago, 1982.

Google Scholar

D.Diamond and P.Dybvig. “Bank Runs, Deposit Insurance, and Liquidity.” *Journal of Political Economy* **91** (June 1983), 401–19.

Web of Science® | Google Scholar

D.Draper and J.Hoag. “Financial Intermediation and Theory of Agency.” *Journal of Financial and Quantitative Analysis* **13** (1978) 595–611.

Web of Science® | Google Scholar

M.Flannery. “An Economic Evaluation of Credit Unions in the United States.” Federal Reserve Bank of Boston Research Report, No. 54, 1974.

Google Scholar

M.Flannery. “Financial Intermediation under Uncertainty: A Microeconomic Analysis.” Ph.D. Dissertation: Yale University, 1978.

Google Scholar

S.Grossman and J.Stiglitz. “The Impossibility of Informational Efficient Markets.” *American Economic Review* **70** (1980), 393–408.

Web of Science® | Google Scholar

J.Hirshleifer. “The Private and Social Value of Information.” *American Economic Review* **61** (1971), 561–74.

Web of Science® | Google Scholar

M.Jensen and W.Meckling. “The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* **3** (1976), 305–60.

CAS | Web of Science® | Google Scholar

M.Klein. “A Theory of the Banking Firm.” *Journal of Money, Credit and Banking* **3** (1971), 205–18.

Google Scholar

H.Leland and D.Pyle. “Information Asymmetries, Financial Structure, and Financial Intermediation.” *Journal of Finance* **32** (1977), 371–87.

Web of Science® | Google Scholar

J.McCall. “Economics of Information and Job Search.” *Quarterly Journal of Economics* **84** (1970), 113–26.

Web of Science® | Google Scholar

D.Pyle. “On the Theory of Financial Intermediation.” *Journal of Finance* **26** (1971), 737–48.

Web of Science® | Google Scholar

D.Pyle. “Descriptive Theories of Financial Institutions.” *Journal of Financial and Quantitative Analysis* **7** (1972), 2009–30.

Web of Science® | Google Scholar

W.Sharpe. “Capital Asset Prices: A Theory of Market Equilibrium under Condition of Risk.” *Journal of Finance* **19** (1964), 425–42.

Web of Science® | Google Scholar

M.Spence. “Competitive and Optimal Responses to Signals: Analysis of Efficiency and Distribution.” *Journal of Economic Theory* **7** (1974), 296–332.

Web of Science® | Google Scholar

J.Stiglitz. “Information and Economic Analysis.” In M. Parkin and A. Nobay (eds.), *Current Economic Problems*. Cambridge, England: Cambridge University Press, 1975.

Google Scholar

J.Stiglitz. “Information and Capital Markets.” In W. Sharpe and C. Cootner, (eds.), *Financial Economics*. New York: McGraw-Hill, 1982.

Google Scholar

Citing Literature