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# Monitoring the monitor: An incentive structure for a financial intermediary *

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This paper studies financial intermediation (i.e., delegated monitoring) in a costly state verification model. There are a finite number of agents, thus the intermediary cannot fully diversify its portfolio and is subject to default risk. The role of the intermediary is to satisfy simultaneously the different portfolio preferences of borrowers and lenders. Two questions arise when a delegated monitor is subject to non-trivial default risk: (a) What arrangement solves the problem of monitoring the monitor? (b) What intermediary portfolio accomplishes optimal asset transformation between borrowers and lenders? Unlike previous delegated monitoring studies, the *law of large numbers* is not sufficient to obtain our results. Instead, we appeal to a stronger results, the *large deviation principle*, which establishes that convergence in the law of large numbers is exponential.

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