

# **Lesson 7: Understanding Financial Contracts**

In this lesson we will learn about the relationship between types of financial contracts and the characteristics of the business environment, including business size and cultural background.

**Suggested reading: RSU chapters 14 and 16**

# The Problems “to be solved”

- Asymmetric information

- Adverse selection

- used cars
    - bank loans



- **stockholder-lender conflict:** firm owners have an incentive to understate their true riskiness in order to borrow on more favorable terms

- management

- **manager-stockholder conflict:** selecting a bad partner.

- Moral hazard

- insurance
    - bank loans

- **stockholder-lender conflict:** firms (managers and owners) have an incentive to become riskier after their loans are funded (limited liability)

- management

- **manager-stockholder conflict:** ownership versus control – different incentives, ambiguous information (when is the CEO really wasting time?) - principal-agent

# Defining Dimensions

- Small, medium and large businesses
  - Size influences the type of financing appropriate and available for a business
- Markets-oriented versus banking-oriented systems.
  - **Banking-oriented:** reliant on close relationships between banks and businesses
  - **Markets-oriented:** suspicious of close relationships between banks and businesses

# Problems and Dimensions - 1

<b>Size</b>	<b>Small</b>	<b>Larger</b>
<b>Type of conflict</b>		
<b>Stockholder-lender (risk-shifting)</b>	<b>major problem</b>	<b>minor problem</b>
<b>Manager-stockholder (corporate governance)</b>	<b>none</b>	<b>major problem</b>

# Small Businesses

- Less than \$10 million in asset value
- Usually privately owned – bear the stamp of the owner-manager - no owner-manager conflict
- Find the right bank, establish a relationship
- Frequent use of personal surety and collateral (secured vs. unsecured loans).
- The role of restrictive covenants – have to be prepared and monitored
- Relatively short time horizons
- Moral hazard and adverse selection apply

# Midsize Businesses

- Between \$10 million and \$150 million
- Large enough to be somewhat independent of the bank – but not large enough to use the public bond or stock markets.
- Manager-owner can be a problem (also multiple partners)
- Use letters of credit (revolving credit) in addition to bank loans
- Use private placements – does not have to be registered with the SEC – are non traded (life insurance companies play a large role)
- Often have covenants and collateral attached
- Find the right agent, he/she does due diligence, constructs a contract, markets the deal (offering memorandum), gets investors, they do due diligence – investor funding.

# Large Businesses

- Over \$150 million in asset value
- Much more likely to use the public markets and therefore must comply with SEC regulations, especially “full disclosure”
- Both manager-owner and borrower-lender conflicts are possible
- Find an underwriter (syndicate), due diligence, registration statement, preliminary offering prospectus, commitment price, terms and spread, no restrictive covenants – contracts more standardized, ongoing financing (shelf registration)
- Short term versus long term – corporate bonds, notes and commercial paper
- Information is “public” – monitoring is done by the “public” – moral hazard more than adverse selection.

# Summary: Business Size and Financial Contracts

<b>Characteristic</b>	<b>Small Business (bank loans)</b>	<b>Midsize Business (private market)</b>	<b>Large Business (public market)</b>
<b>Maturity</b>	short	long	long
<b>Rate</b>	floating	fixed	fixed
<b>Covenants</b>	many, tight	fewer, looser	fewest
<b>Collateral</b>	very often	often	infrequent
<b>Investor monitoring</b>	intensive	significant (venture capital)	minimal
<b>Renegotiation frequency</b>	high	medium	low
<b>Origination</b>	direct	agents	underwriter

# It's All About Trust



- Asymmetric information is particularly acute for small firms because there is very little publicly available information
- Moral hazard & adverse selection are problems for the borrower as well as the lender – particularly if the borrower is trust-worthy
- Consumer loans – though they are “small” asymmetric information may be less of a problem
  - consumers are sometimes easier to assess – personal financing information is more available and less complex
  - there are relatively few types of consumer loans
  - Collateral is often available to eliminate the asymmetric information problem
- Securitization is often possible – example, mortgages

# Problems and Dimensions - 2:Types of Market

## (a) Banking-Oriented Systems

<b>Size=&gt; Type of conflict</b>	<b>Small</b>	<b>Larger</b>
<b>Stockholder-lender (risk-shifting)</b>	<b>financial intermediation (monitoring)</b>	<b>financial intermediation (ownership consolidation)</b>
<b>Manager-stockholder (corporate governance)</b>	<b>not applicable</b>	<b>financial intermediation (ownership consolidation)</b>

## (b) Markets-Oriented Systems

<b>Size=&gt; Type of conflict</b>	<b>Small</b>	<b>Larger</b>
<b>Stockholder-lender (risk-shifting)</b>	<b>financial intermediation (monitoring)</b>	<b>reputation and rating agencies</b>
<b>Manager-stockholder (corporate governance)</b>	<b>not applicable</b>	<b>takeover market and managerial compensation</b>

# The Big Four

Markets-Oriented	Banking-Oriented
USA UK	Japan Germany

# Markets in Transition

- Eastern Europe
- Africa, Asia, the Middle East
- Products of human action not of human design?