ISSN: 2993-8732

DOI: 10.33552/IJEBM.2023.01.000521

Iris Journal of
Economics & Business Management

Iris Publishers

Opinion

The Good Face of Private Financing

Shayan Dashmiz*

Columbia Business School, USA

Corresponding author: Shayan Dashmiz, Columbia Business School, USA.

Received Date: August 29, 2023

Published Date: September 20, 2023

Introduction

Financial intermediaries are associated with superior information. Examples of informed financial agents are private equity firms which rely heavily on information acquisition and monitoring. A monitoring agent can monitor the firm to make sure the firm operation is in check so that the firm. extracts a minimum level of value. However, there can be harder monitoring in place so that the entrepreneurs extract the highest level of effort or the probability of success is improved using the expertise of private financiers. At the extreme, a private financier can change the management and operation structure of the firm.

For instance, private equity is based on improving the management team and reducing the frictions and risks within the firm (Bacon et al. (2012)). The role of monitoring has been studied extensively in literature. Holmstrom and Tirole (1997) an important contribution that considers financial intermediaries who can monitor projects to keep the entrepreneurs in check but do not consider a value improvement from the monitoring agents. In Diamond (1991) also considers the interaction of reputation and bank monitoring and a choice between public placement and bank debt. In Diamond (1991) the role of monitoring is acquiring information for the entrepreneur's choice of action and there is no value improving role (which can be the case in reality for banks). It worth to note two different forms of monitoring: soft and hard monitoring. The term "Soft Monitoring" refers to the case where the entrepreneur's private benefits of shirking are reduced by, as a usual example, a monitoring bank. I refer to "Hard Monitoring" to the case where not only the entrepreneur is disciplined but the firm value is improved to its maximum possible level by improving the risk and management structure within the firm. Moreover, when a firm is under intense monitoring, the financier can pour more capital to the firm to benefit from the high expected growth. There is a public belief that financial institutions can exploit public markets as they informed agents has access to superior information and vast amounts of capital. If this hypothesis is correct, the finance sector should grow disproportionately compared to the public sector, which is indeed the case as confirmed in Philippon and Reshef (2012) and Philippon (2015). Rent-seeking is a known and simple mechanism that can lead to higher rents for informed agents. Informed intermediaries can invest in the best projects to make positive rents and leave the uninformed with low-quality projects (Bolton et al. (2016)). An important question in this context is the value of financial markets for the society.

There is indeed a positive role of the finance sector for social surplus as well. This positive role was probably the first reason the finance sector evolved. Financial sector can direct capital to the best projects and more importantly provide a scale for investment. Therefore, there is a direct effect of private financing for the social surplus. In this note, I discuss how there can be also indirect effects of private financing for social surplus. The private financing sector is equipped with a monitoring technology that can boost the pledge able income and prospect of success within a firm. This can increase the profits and value in the private sector by improving the management and financing capacity of the firms managed by the private equity sector. Noe, let's explain the indirect positive role of private equity in simple terms. If there is a pool of firms, the private equity agent can improve the value in the firms that were shocked by bad management. Thus, private financing can lead to a pool of low-risk firms for the public investors which would translate to more financing as now the uncertainty of investing in the pool is reduced. This mechanism ensures that private equity has a positive indirect effect for the public market as well by making it lessrisky and the pool of firms more high quality in the public market. Therefore, there can be a good face for private financiers and this is how a private profit-seeking activity can lead to higher social surplus both in private and public markets. For future research, one can look for empirical dependency of private and public markets to quantify how there can be spillover effects of private financing.

Acknowledgement

None.

Conflict of Interest

No conflict of interest.

References

1. Bacon N, Wright M, Meuleman M, Scholes L (2012) The impact of private equity on management practices in european buy-outs: short-termism, anglo-saxon, or host country effects? Industrial Relations: A Journal of Economy and Society 51: 605-626.
2. Bolton P, Santos T, Scheinkman JA (2016) Cream-skimming in financial markets. The Journal of Finance 71(2): 709-736.
3. Diamond DW (1991) Monitoring and reputation: The choice between bank loans and directly placed debt. Journal of political Economy 99(4): 689-721.
4. Holmstrom B, Tirole J (1997) Financial intermediation, loanable funds, and the real sector. the Quarterly Journal of economics 112(3): 663-691.
5. Philippon T (2015) Has the us finance industry become less efficient? on the theory and measurement of financial intermediation. American Economic Review 105(4): 1408-1438.
6. Philippon T, Reshef A (2012) Wages and human capital in the us finance industry: 1909–2006. The Quarterly Journal of Economics 127(4): 1551-1609.