Dissertation Proposal

Essays on Financial Intermediation and Economic Linkages

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The first essay studies the design and welfare implications of basket securities issued in markets with limited investor participation. Profit-maximizing issuers exploit investors' inability to trade freely across different markets and choose which market to specialize in. I show that when the issuer is a monopoly, the equilibrium may not be constrained efficient. Increasing competition among issuers increases the variety of baskets issued, but does not always improve investors' welfare. Although competition increases the variety of baskets issued, many of these baskets are redundant in the sense that coordination among issuers may improve investors' risk sharing opportunities. The equilibrium basket structure depends on institutional features of a market such as depth and gains from trade.

The second essay - joint with Nicolas Figueroa (Universidad Catolica de Chile) and Oksana Leukhina (University of Washington) - studies the interaction of information transmission in secondary loan markets and screening effort at loan origination. Originating banks are able to identify repaying borrowers at a cost, but they cannot credibly transmit such information in secondary loan markets. Banks may choose then to employ credit ratings to convey borrowers' credit worthiness to investors. The price differential on assets with high and low ratings emerges then as the main determinant of screening effort. We find that rising collateral values and increasing asset complexity help explaining the following pre 2008 financial crisis observations: (1) laxer screening standards, (2) intensified rating shopping, (3) rating inflation, and (4) the decline in the differential between yields on assets with low and high ratings. Surprisingly, we find regulatory policies, such as mandatory rating and mandatory rating disclosure, to be counterproductive, both exacerbating resource misallocation.

The third essay studies how the relative importance of a firm in a network of business relations impacts its expected return and volatility. I map the characteristics of the business network topology to the cross sectional return and volatility distributions. The analysis intends to determine whether well-connected firms are riskier than others provided their higher exposure to aggregate risk through their business relations. Despite well-connected firms may have higher chances of being affected by those negative shocks affecting their linked firms, a firm's business relations may help a firm hedge its risk of contagion. Therefore, whether more central firms earn higher expected returns - compared to peripheral firms in the economy - may depend on other firms' characteristics.