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GUEST EDITOR'S INTRODUCTION

The Blurring of Boundaries between Financial Institutions and Markets

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The papers in this issue explore the blurring of boundaries between the activities of financial institutions and public markets as means for firms to raise capital—both causes and consequences. The purpose of this article is to provide a perspective that connects these papers and outlines an agenda for future research. To think about the blurring of boundaries, we need know why there are boundaries in the first place. Why do firms seek intermediated capital rather than always going directly to the ultimate providers of capital?

There are a number of reasons, as summarized, for example, in the survey of Bhatacharya and Thakor (1993). Intermediaries can screen firms of different quality and can monitor asset substitution moral hazard. Consistent with the moral-hazard monitoring role of banks, Esho, Lam, and Sharpe, in their paper in this issue, "Choice of Financing Source in International Debt Markets," provide evidence of debt financing by Asian firms during the late 1980s and the 1990s showing that firms that had a greater probability of financial distress were more likely to obtain an internationally syndicated bank term loan. In addition to monitoring, some intermediaries such as VCs play an important role in managerial transitions and offer monitoring and certification both to investors and to input and product market participants.

Of course, investors acting individually can try to perform monitoring functions themselves. However, this involves replicating costs of monitoring (as analyzed, for example, in Diamond (1984)). This leads to scale economies in monitoring. These economies can be realized by creating a financial intermediary that raises capital from investors and invests in the firm being monitored.

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Alternatively, the monitors can be investment advisors who simply provide information to individuals who wish to invest directly. Thus, at first glance it would seem that the distinction is between intermediated and nonintermediated investments, rather than between intermediation and markets. However, if an intermediary seeks to sell an investment it has monitored, an adverse selection problem is created for the buyer. Thus, intermediated investment tends to be far less liquid than securities traded in public markets. It follows that, as emphasized by Boot and Thakor (1997), nonintermediated markets have an important advantage of their own, which is that they can aggregate information possessed by investors that can be useful for firms' investment decisions. Allen and Gale (1999) offer a somewhat different advantage of nonintermediated finance. Since markets allow investors to choose on a project-by-project basis what to fund, markets may be especially good at funding new technologies about which there is a diversity of beliefs.

The boundaries between institutions and markets have always been somewhat permeable, of course. Public capital markets are intermediated by investment banks and auditors that are also to some extent certifiers of quality (a role analyzed by Titman and Trueman (1986)). For example, there is evidence that stock markets value IPO firms more that are brought to the market by a well-known underwriter (see Beatty (1986), and Carter *et al.* (1998)) or that are audited by a large accounting firm (see Beatty (1989) and Michaely and Shaw (1995)), and that underwriters that do a poor job monitoring lose market share (Nanda and Yun (1997)). Investors also place more credence on the reported earnings of firms that are audited by a well-known accounting firm (Teoh and Wong 1993). Other professional stock and bond market monitors include analysts and credit rating agencies; venture capitalists manage the transition from private to public ownership, and leveraged buyout firms the reverse.

By the same token, intermediaries to some extent engage in routine transaction activities that involve little monitoring. For example, with a few notable exceptions, most pension funds and mutual funds generally do not attempt to influence management actions. And, as analyzed by Boot and Thakor (2000), banks engage in relationship lending, which involves special expertise and high monitoring, and also in transactions banking that involves little monitoring. For example, banks that securitize loans that they had originated are in large part providing transactions services (which is perhaps another name for fairly mechanical rather than sophisticated monitoring). Relationship lending is costlier than transaction lending, but adds more value for borrowers about whom there is severe moral hazard or adverse selection problems.

The rise of securitization, in which the holder of a pool of many risky fixed-income assets issues tradable security claims to the cash flows generated by these assets, has been one important respect in which the boundaries between banks and public markets have grown blurred. This can be viewed as part of the general historical trend, as markets have grown in sophistication, of a movement from relationship financing to liquid capital markets. The Thomas paper in this issue,

"Effects of Asset Securitizations on Seller Claimants," examines the conversion of intermediated loans to publicly traded debt. He reports the benefits to different kinds of sellers of securitized debt under different market conditions. For example, securitization has been wealth increasing for large and frequent securitizers.

A second source of greater blurriness is deregulation, which has allowed U.S. banks greater scope to engage in market-related activities. Thomas reports that there is some indication that securitizations help some institutions avoid regulatory burden. More broadly, the move to blurriness may be a move toward optimality as inefficient obstructions to efficient contracting are gradually laid aside. Related to deregulation is international competition, which encourages countries to permit financial architectures conductive to economic growth. Firms that are healthy enough and able enough to meet reporting standards gain access public markets, which provides a freedom from dependence upon, and bargaining problems with, an intermediary. Thus, gaining access to public international markets can be valuable for a firm that desires flexibility in its strategy for growth (see, e.g., Doidge *et al.* (2001)). Esho, Lam, and Sharpe report that firms in countries with well-developed private bond markets were more likely to access international bond markets.

Perhaps most importantly, the blurring of boundaries probably represents growing exploitation of the competitive strengths of different kinds of intermediaries, and the complementarities of these strengths with public markets. For example, the large capital bases of commercial banks provide them with some competitive strengths in some investment banking services relative to investment banks, and the skills in marketing to individual investors of mutual fund and brokerage companies provides them with advantages in competing with traditional banking services such as checking accounts. It is likely that blurring of boundaries between intermediaries and markets will develop in complex and not entirely predictable ways, leading to outcomes more efficient than financial theorists can understand in advance.

I will close by suggesting some possible directions for further research. In recent years there has been growing recognition by finance academics that investors behave in an imperfectly rational fashion, and that this affects their investment outcomes. There is evidence suggesting that firms actively exploit the imperfect rationality of investors. For example, firms buy back shares from investors prior to abnormally good post-repurchase return performance (see, e.g., Ikenberry *et al.* (1995)), issue shares to investors prior to abnormally bad post-issuance return share performance (Loughran and Ritter (1995)), and adjust their accounting numbers upward at the time of new issues (e.g., Teoh *et al.* (1998ab)). This suggests that intermediaries can play a valuable role in protecting investors from their own inattention or irrational enthusiasms. It further suggests that the governance and monitoring roles of intermediaries may be even more important than fully rational approaches may suggest. At the same time, it also suggests a darker side of intermediation, the participation by financial intermediaries in exploiting the biases of investors. These issues offer rich new territory for exploration.

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