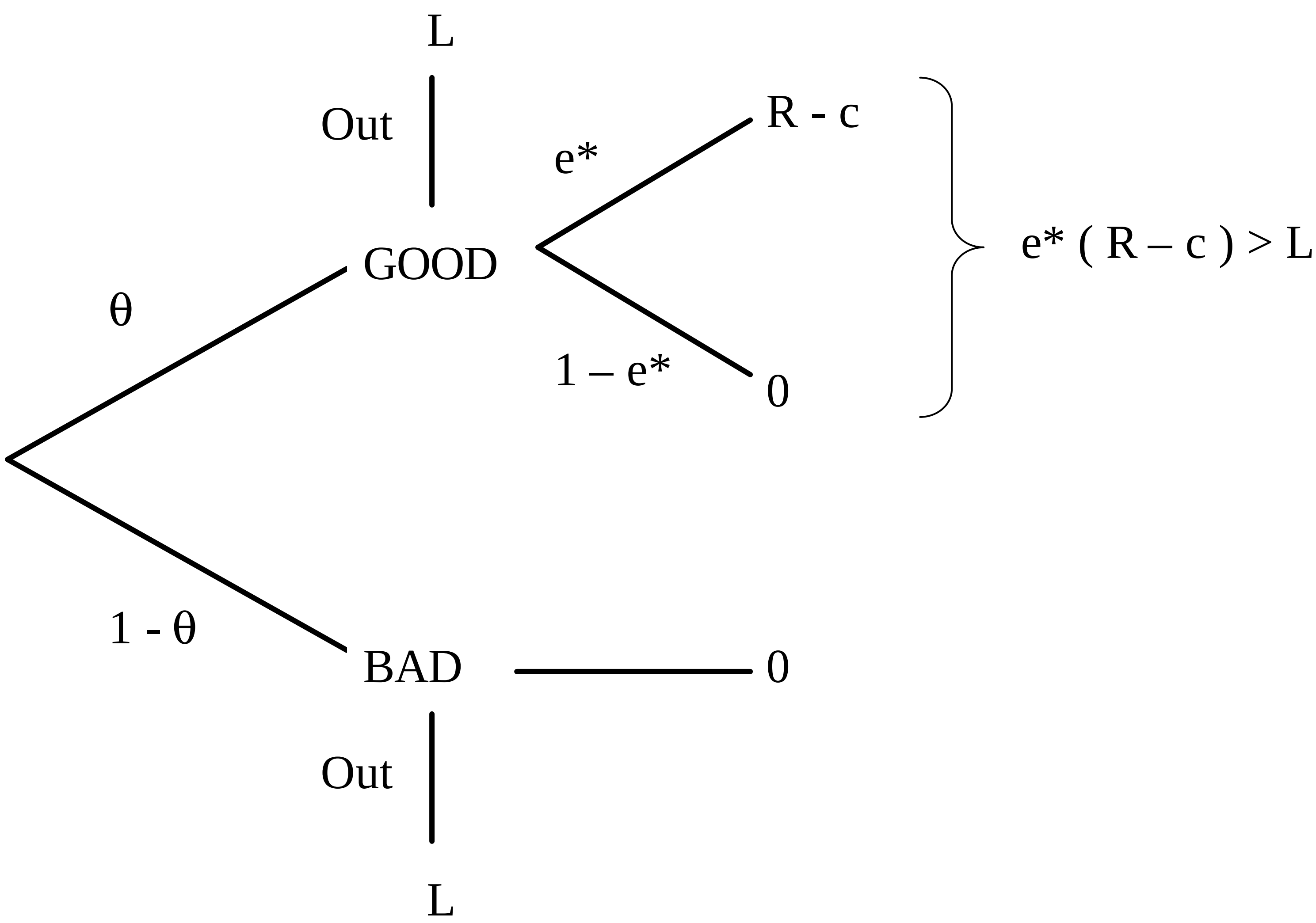
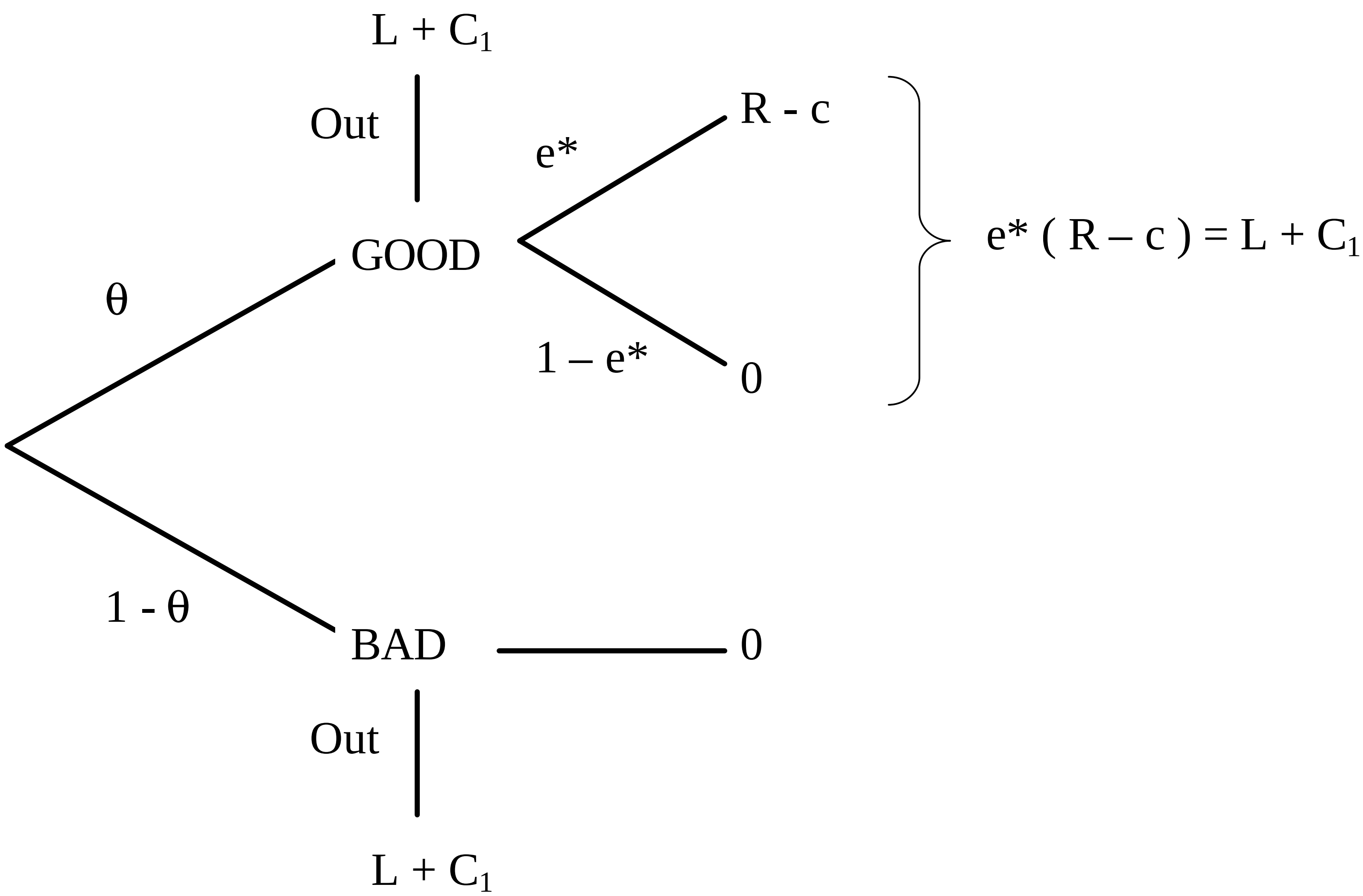
INTRODUCTION

- Diagram of the game and key results
- Capital constraints
- Monitoring incentive and disclosure requirements

GAME WITHOUT PROTECTION



GAME WITH EARLY PROTECTION



KEY RESULTS

- Early protection implement first best solution
- Disclosure of information implies buying early protection
- Disclosure of information to the borrower
- Disclosure of information before borrower chooses effort

CAPITAL CONSTRAINTS

- $K = K_{FIRM} - \underline{K}$
- Required capital is a function of investment's risk
- Basel II : $\underline{K}$ is a function of $C_2 \Rightarrow K(C_2)$
- Basel II : $\underline{K}$ is a also a function of $C_1 \Rightarrow K(C_1, C_2)$
- Does Basel II take into account the benefits of the incentive enhancement implied by early protection?

MONITORING INCENTIVE AND DISCLOSURE REQUIREMENTS

- Pure strategy equilibrium with monitoring if:

$$(1 - \theta)(L + C_1) \geq c \quad \text{and} \quad L \geq c$$

- Pure strategy equilibrium *without* monitoring is still possible
- Cost of monitoring (c) must be known by the borrower otherwise a mixed strategy equilibrium might be the best response for the borrower.