INTRODUCTION

• Diagram of the game and key results

• Capital constraints

• Monitoring incentive and disclosure requirements
GAME WITHOUT PROTECTION

\[ e^* \left( R - c \right) > L \]
GAME WITH EARLY PROTECTION

\[ e^* (R - c) = L + C_1 \]
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

- $K = K_{\text{FIRM}} - K$
- Required capital is a function of investment’s risk
- Basel II: $K$ is a function of $C_2 \Rightarrow K(C_2)$
- Basel II: $K$ 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 \textit{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.