Bank as a Venture Capitalist

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Abstract

Traditional banks finance entrepreneurs through loans. But more ingenious banks explore other forms of financing, such as venture capital (VC), as well. In this paper, I argue that the banks offer VC together with traditional (collateralized) loans in response to the natural constraints of asymmetric information that they face. Innovative entrepreneurs pursue new technology that promises a high return but runs a high risk of failure. The more innovative entrepreneurs also have higher reservation utility. This interaction between type dependent return and reservation utility creates a situation where collateral alone is not sufficient to screen entrepreneurs and the bank needs an additional screening device. VC fulfils that role. I also introduce a fairly general returns function that can generate various risk–expected returns relations, including a risk–expected returns trade-off.

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