

Off-Balance Sheet Funding, Voluntary Support and Investment Efficiency

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Abstract:

Financing an investment off-balance sheet gives a bank the option, but not the obligation, to use its funds to voluntarily support debt repayments when the investment fails. Such flexibility, which is absent with on-balance sheet funding, allows the bank to signal information about the quality of its future projects, improving investment efficiency. Yet, off-balance sheet funding reduces the bank's skin-in-the-game and its incentives to exert effort. Off-balance sheet funding with voluntary support emerges as the optimal funding mode for activities that are rapidly growing or negatively correlated with existing assets.