Abstract of
"A Contracting Approach to Risk-Shifting Behavior and Trade Credit"

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We explore a capital allocation problem following a loan contracting decision within an optimal contracting approach and show that the incentive of risk-shifting behavior results in both under and over-investment dependent on the level of self-owned capital. We also examine the effect of trade credits and show that trade credit makes under-investment situation more likely. Furthermore, we consider the difference of priority between trade credit and bank debt and then show that giving the security interest to the bank can eliminate the enhanced incentive of risk-shifting behavior due to the usage of trade credit and heighten the firm's value.

Keywords: Debt Contract, Asset Substitution, Trade Credit, Secured Debt.
JEL Classification: G11, G31, G32.

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