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Investment origination and screening: Separation or integration?

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Abstract

Financial intermediaries differ in how they organize project origination and screening: banks often separate these tasks across divisions, while venture capital firms typically integrate them. This paper develops a simple moral-hazard model in which origination effort is unobservable but screening is contractible and perfectly reveals project quality. The key determinant of organizational form is the principal's rational default investment decision absent screening---approve or decline---which, in the model, is pinned down by the expected net payoff of investing without screening. When default approval is optimal, integrating origination and screening creates an incentive conflict: screening reduces the probability that the agent receives the approval-contingent reward needed to motivate origination, making separation optimal. When default decline is optimal, this conflict disappears and integration can dominate. The model thus delivers a simple rationale for why banks tend to separate origination and screening, while venture capital organizations tend to integrate them.

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1. Introduction

A salient organizational difference between banks and venture capital firms concerns how they allocate two sequential tasks in investment selection: project origination (sourcing deals or managing client relationships) and screening (evaluating projects prior to investment). Banks typically separate these tasks across divisions—relationship managers originate while independent credit or risk units screen and approve—whereas venture capital partnerships often integrate them, with the same investors sourcing and diligencing deals. What determines whether separation or integration is optimal?

This note provides a simple incentive-based explanation. While banks and venture capital firms differ in many crucial institutional dimensions (e.g., debt vs. equity financing, maturity, and governance), this paper develops a parsimonious model focusing on a single reduced-form feature: the principal's rational default decision absent screening, summarized by the expected net payoff of investing without screening. A principal can either hire two agents and assign origination and screening separately, or hire a single agent and integrate the tasks.

Origination effort is unobservable and must be motivated through an approval-contingent reward, while screening is contractible and (for simplicity) perfectly reveals project quality. The key driver is the principal's rational default decision absent screening.

- In bank-like environments, the pool of originated opportunities is sufficiently likely to be good that, absent additional screening, approving can be a rational default decision.
- Venture capital, in contrast, operates a screening funnel: survey evidence indicates that a typical VC firm screens roughly 200 potential investments but closes only about four per year (Gompers et al., 2020), suggesting that absent due diligence the default stance is to decline.

Importantly, "default decline" does not mean that VC-backed projects have negative expected returns. Venture investing frequently involves high-growth opportunities and experimentation with staged financing and learning (Puri and Zarutskie, 2012; Ewens et al., 2018). Our static model abstracts from these dynamics and captures a single screening gate: absent due diligence (i.e., without exercising the real option to learn), the principal rationally declines and proceeds only after screening reveals a good type.

This rational default decision determines how integration affects incentives. Under default approval, screening lowers the probability that the agent earns the approval-contingent reward used to incentivize origination, generating an incentive conflict under integration. Separation avoids this conflict because screening incentives can be provided independently. Under default decline, this conflict disappears, and integration becomes attractive.

The main result is a sharp organizational comparative static: under mild conditions ensuring that inducing both efforts is efficient, the principal chooses separation when the default decision is approval and integration when it is decline. This yields a parsimonious rationale for why bank-like environments tend to feature separated origination and screening, while venture-capital settings tend to integrate them.

This note relates to entrepreneurial finance research on how banks and venture capitalists differ in screening and governance (Ueda, 2004; Sahlman, 1990; Kaplan and Strömberg, 2004).

A separate literature studies internal bank organization—loan review and risk management—as devices to discipline origination incentives and improve credit outcomes (Udell, 1989; Berg, 2015). Finally, the analysis builds on organizational economics on multitasking and task allocation (Holmström and Milgrom, 1991; Khalil et al., 2006). Relative to these literatures, the contribution here is to show how average project profitability pins down the default decision (approve vs. reject), and thereby determines whether integrating origination and screening creates or removes an incentive conflict.

2. Model

A principal allocates two tasks in investment selection: *origination* (sourcing a project) and *screening* (evaluating it before investment). The principal can assign these tasks to two agents (*separation*) or to one agent (*integration*). Contracts are contingent on the investment decision and, if applicable, on whether screening is performed.

A project requires investment $I > 0$ and is either good or bad. A good project yields payoff $R > I$, while a bad project yields 0.

Origination. The originator can exert unobservable effort at cost $c_O > 0$, which raises the probability of a good project from p_L to $p_H > p_L$. Let $\Delta p \equiv p_H - p_L > 0$. Due to limited liability, the originator can be rewarded only with a nonnegative approval-contingent payment $w_A \geq 0$ (the rejection payment is normalized to zero).[1]

Screening. Screening, if performed, costs $c_S > 0$, is observable and contractible, and perfectly reveals project type. Let $w_S \geq 0$ denote the contractible payment for performing screening.

Timing. The principal offers (w_A, w_S), the relevant agent(s) choose effort, the principal observes any screening outcome and then approves or rejects the project, and payoffs are realized.

Separation vs. integration. Under separation, origination and screening are carried out by two agents, so incentives can be set separately. Under integration, one agent controls both actions, so the screening decision affects the likelihood of receiving the approval-contingent reward w_A; consequently, the principal's *default* decision absent screening (approve vs. reject) plays a central role. The next section solves for optimal contracts under each organizational form and compares profits.

[1] Allowing a rejection payment does not affect the results, as it is optimally set to zero under limited liability.

3. Results

3.1 Separation

Under separation, the screening agent's participation constraint is

$$-c_S + w_S \geq 0,$$

and the originating agent's incentive constraint is

$$-c_O + p_H w_A \geq p_L w_A.$$

The principal chooses (w_A, w_S) to maximize $-w_S + p_H(R - I - w_A)$ subject to these constraints. The optimal contract sets both constraints at equality:

$$w_A^{\text{sep}} = \frac{c_O}{\Delta p}, \qquad w_S^{\text{sep}} = c_S,$$

yielding

$$\Pi^{\text{sep}} = -c_S + p_H\left(R - I - \frac{c_O}{\Delta p}\right).$$

I impose the following assumption to ensure that inducing both origination and screening is optimal under separation:

Assumption 1. $\Pi^{\text{sep}} > p_L R - I$, and $\Pi^{\text{sep}} > -c_S + p_L(R - I)$.

3.2 Integration

Under integration, a single agent undertakes both tasks. As in the separation case, the origination incentive constraint implies

$$w_A^* = \frac{c_O}{\Delta p}.$$

Let the *default investment decision* be the principal's action in the absence of screening. This decision is determined by the expected profitability of an originated project:

$$p_H R - I - w_A^*.$$

The default is approval if this expression is nonnegative (bank-like environment), and decline otherwise (VC-like environment). Consequently, an agent who deviates by not screening receives w_A under default approval and 0 under default decline.

Case A: default approval. To induce screening, the relevant incentive constraint is

$$-c_O - c_S + w_S + p_H w_A \geq w_A,$$

which implies, after substituting $w_A^* = c_O/\Delta p$,

$$w_S \geq c_S + (1 - p_L)\frac{c_O}{\Delta p}.$$

Thus the optimal contract is

$$(w_A, w_S) = \left(\frac{c_O}{\Delta p},\, c_S + (1 - p_L)\frac{c_O}{\Delta p} \right),$$

and the resulting profit is

$$\Pi_A^{\text{int}} = -c_S - (1 - p_L)\frac{c_O}{\Delta p} + p_H \left(R - I - \frac{c_O}{\Delta p} \right) = \Pi^{\text{sep}} - (1 - p_L)\frac{c_O}{\Delta p}.$$

Case D: default decline. Under default decline, if the agent does not screen, the principal rejects by default. The agent then earns no approval-contingent payment and therefore would not optimally incur the origination cost. Accordingly, to induce *both* origination and screening, the relevant (joint) incentive constraint is

$$-c_O - c_S + w_S + p_H w_A \geq 0.$$

As before, the origination incentive constraint given screening is $\Delta p\, w_A \geq c_O$, so $w_A^* = c_O/\Delta p$. Substituting w_A^* into the joint constraint gives

$$w_S \geq c_S - p_L \frac{c_O}{\Delta p}.$$

Limited liability implies $w_S \geq 0$, so the optimal contract is

$$(w_A, w_S) = \left(\frac{c_O}{\Delta p},\, \max\left\{ 0,\, c_S - p_L \frac{c_O}{\Delta p} \right\} \right),$$

and the resulting profit is

$$\Pi_D^{\text{int}} = p_H \left(R - I - \frac{c_O}{\Delta p} \right) - \max\left\{ 0,\, c_S - p_L \frac{c_O}{\Delta p} \right\} = \Pi^{\text{sep}} + \min\left\{ c_S,\, p_L \frac{c_O}{\Delta p} \right\}.$$

Proposition 1. *Under Assumption 1, the principal optimally chooses separation if the default investment decision is* approval*, and integration if it is* decline*.*

Proof (sketch). From the expressions above,

$$\Pi_A^{\text{int}} = \Pi^{\text{sep}} - (1 - p_L)\frac{c_O}{\Delta p} < \Pi^{\text{sep}}, \qquad \Pi_D^{\text{int}} = \Pi^{\text{sep}} + \min\left\{ c_S,\, p_L \frac{c_O}{\Delta p} \right\} > \Pi^{\text{sep}}.$$

Hence separation is optimal under default approval, while integration is optimal under default decline. □

4. Conclusion

This paper studies how a principal should organize two sequential tasks in investment selection: project origination and screening. The key organizational choice is whether to assign

these tasks to different agents (separation) or to a single agent (integration) when origination effort is unobservable but screening is contractible and can perfectly reveal project type.

The main result is that the optimal organization depends on the principal's rational default investment decision absent screening (approve vs. reject), which in the model is pinned down by the expected net payoff of investing without screening. When default approval is optimal (Default Approval), integrating tasks creates an incentive conflict because screening reduces the likelihood that the agent earns the approval-contingent reward needed to motivate origination; separation avoids this conflict and dominates. Conversely, when default decline is optimal (Default Decline), the conflict disappears and integration becomes preferable.

This yields a simple, unified rationale for the organizational dichotomy observed in finance:

- Banks, which often operate in settings where proceeding absent intensive screening is a plausible default, tend to separate origination and screening.
- Venture capital partnerships, which operate a high-rejection screening funnel, tend to integrate these functions.

An important implication is that changes in the profitability of originated projects can endogenously shift the optimal internal boundary of financial intermediaries. More broadly, the analysis highlights that organizational form can be determined by the interaction between the default decision absent screening and incentive provision, even while deliberately abstracting away from complex institutional differences like debt versus equity, thereby showing the robustness of this single mechanism.

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