The Information Advantage of Banks: Evidence From Their Private Credit Assessments

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The Information Advantage of Banks
This paper

Motivation:

- Classic theory of financial intermediation highlight that banks mitigate information frictions

Research questions:

Do banks collect and process informed information about borrowers?

This paper:

- Banks private information is not known to outsides
- Idea: Exploit supervisory data on banks' expected loan losses and test whether this information explains stock and bond prices

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This paper

Finding 1

- Bank increases in expected losses associated with underperformance of **79bs** (stocks) and **20bp** (bonds) per quarter - - Strongest effect for small and growth firms
- No effect when banks adjust their expected losses downwards

Finding 2

- Negative relationship between banks' expected losses and their loan supply

Finding 3

- High exposure/ new loan issuance associated with more frequent updates of expected loss assessment
- Credit line drawdowns associated with increase in banks' expected losses

Merits

- Novel supervisory dataset that provides detailed loan level data
- Contributes to fundamental understanding of financial intermediation
- Clever idea to link bank assessments of their borrowers to their stock price reactions
- Paper provides a wide set of convincing empirical tests and robustness tests

The Information Advantage of Banks
Comment 1

- Results of the paper are very convincing

➡ But how surprising are they given what we already know about banks‘ possession of private information

- Paper basically ignores that there is a standardized transmission of information from borrowers to banks during existence of lending relationships
- Banks are in the possession of private information about their borrowers w/o producing information themselves

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Comment 1

- Literature cited on the paper describes banks' standard monitoring process (Minnis and Sutherland, 2017)
- Lending conditions of large banks are generally online available (Commerzbank example next slide)
- Besides there are loan covenants in credit contracts that require borrowers to provide further information

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Comment 1

- Until the fulfillment of all obligations assumed under the loan agreement, the customer will
  - promptly submit to the bank duly signed financial statements and explanations or income tax returns **upon completion**
  - the customer shall provide the bank with **preliminary** financial figures within 5 months after the end of the fiscal year (irrespective of accounting laws)
  - **promptly inform the bank of any events that are significant for the execution of the loan agreement**, particularly with regard to fulfilling payment obligations related to the loan agreement
  - In this context, the customer agrees to **allow the bank to review their financial situation** and any changes thereto, if necessary, by inspecting their books and records.

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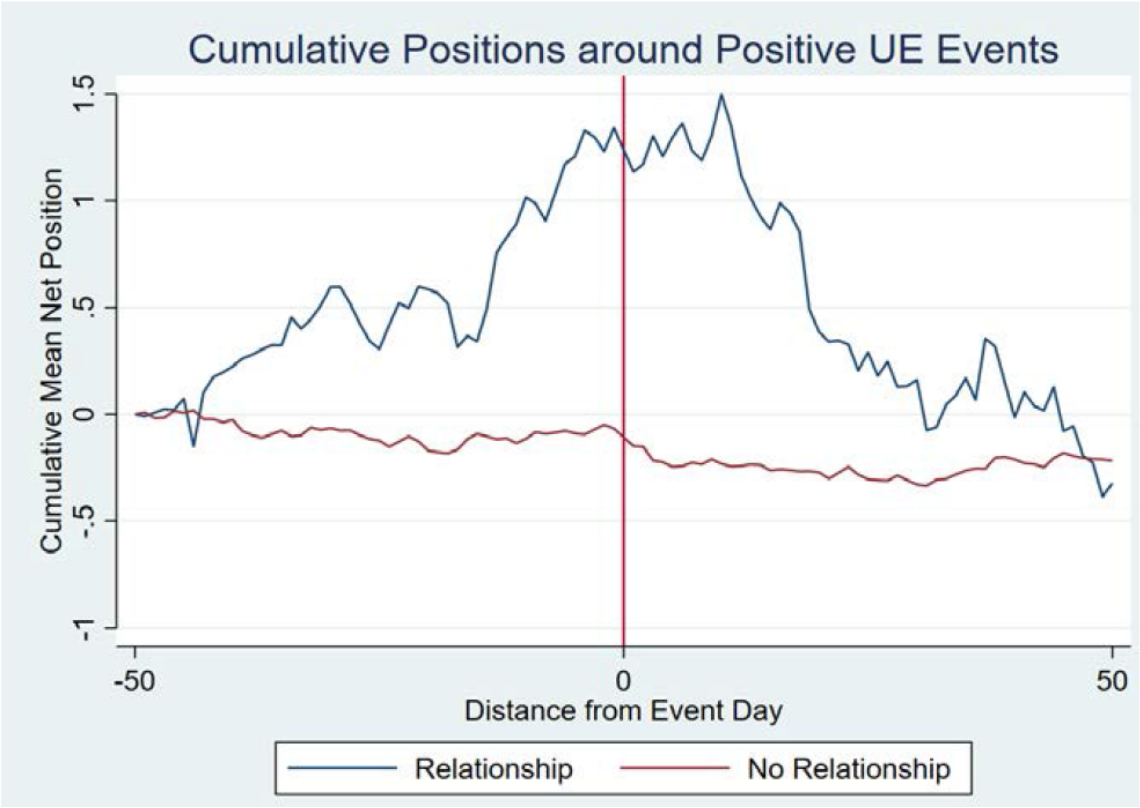
Comment 1

- Banks‘ possession of private information is the rationale
  - ban of banks’ prop trading (Volcker Rule)
  - for the existence ethical walls in universal banks



Source: Haselmann, Leuz and Schreiber (2023)

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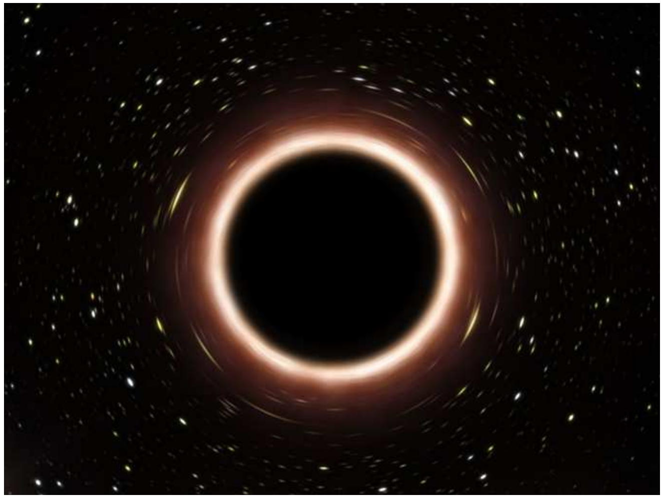
Comment 1

Is it not clear that banks posses private information on their borrowers, but

- Do banks produce information beyond the information they obtain from their borrowers?
- When or for which borrowers do banks audit their borrowers (e.g. some evidence on larger loans, new loans)?

Largely information production and audits by banks remains a black hole



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Comment 2

- Private information and loan commitment (within borrower assessment):

$$Commitment_{i,b,t} = \beta EL_{i,b,t} + \delta_{b,t} + \alpha_{i,t} + \epsilon_{i,b,t}$$

- EL (expected loss) is by definition contract specific, i.e. does not necessary mean that banks’ differ in their assessment or information
- PD is more interesting since it is a borrower specific variable and tells us about banks‘ different assessment of the same firm
- No exogenous shock – bank assessment of losses and changes loan commitment is endogenous
- Use of dummy variables in most specification results in more extreme findings

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Comment 3 / Suggestions

Determinants of banks‘ private information

- Hypothesis:

H1: “On the one hand, banks may be better, or have increased incentives to actively produce information.”

H2: “On the other hand, banks may simply have access to valuable information before markets (Wight et al. (2009)).”

- Not sure whether empirical tests provided are able to differentiate among these hypothesis (note that banks do provide private info before a new loan is issues)
- Could results be explained by bank specialization (that allows them to beat the market)?
- Could you focus on events where firms cannot provide infromation to the bank beforehand (e.g. lawsuits, technology shocks, etc) and see whether banks still do better than markets?

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Summary

- Very interesting paper I recommend everyone to read!

- Careful empirical analysis and novel data

- Some hypothesis could be motivated more carefully

- Paper should differentiate between information that is generally transmitted to banks during their lending relationships and information generated by banks themselves

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Comment 1

- Pay-off structure loan contract: