

Bank Monitoring with On-Site Inspections

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January 6, 2023

Summary

- Monitoring is a key function that banks perform
- Lots of seminal theories e.g. Diamond 84, Pennacchi 88, Boot and Thakor 97, Winton 99, Diamond and Rajan 01, Kashyup, Rajan, and Stein 02...
- Limited empirical evidence, especially direct evidence
- This paper fills an important gap using a novel dataset!
 - 30K construction loans from a large bank over 10 years
 - Records of inspections + inspection reports

Summary

- 1 Monitoring intensity is associated with more favourable loan terms
 - lower spreads and fees
 - larger volumes
- 2 Less monitoring if there is an existing relationship
- 3 More monitoring decreases loan default
 - IV: draw schedules
 - Assumption: ex-ante draw schedules affect loan outcomes only through monitoring intensity

1. Interpretation of Results

- Do we learn about bank monitoring in general?
- “This paper uses construction loan data from the servicing system of a large bank that failed during the financial crisis due to the performance of its primary source of business: single-family home residential lending.”

1. Interpretation of Results

- Do we learn about bank monitoring in general?
- “This paper uses construction loan data from the servicing system of a large bank that failed during the financial crisis due to the performance of its primary source of business: single-family home residential lending.”
- Is this about bank monitoring in general or is it about bank monitoring leading up to default?
- The current pitch is the former
- The latter is perhaps even more interesting!

1. Interpretation of Results

- A key cost of bank defaults is the loss of information of borrowers
- But we know little about
 - What happens to the evolution of monitoring leading up to default?
 - How that affects borrower performance?
 - How should banks going into default be regulated?
 - This is the perfect data to answer these questions!
- Currently: more likely to conduct inspections close to default
 - Why would they be “more cautious”? Agency issues exacerbated?
Different purpose of inspection around default?
- It would be super interesting to shed light on what is going on!

2. What is Monitoring

- Currently, we have
 - Frequency measures of monitoring
 - Number of positive and negative words
- Suggest to look into what else is in the reports to understand how banks monitor
- Based on the findings, could define additional notions of monitoring intensity/effort
- Does the way of monitoring change over the lifecycle of the loan and closer to bank default?

3a. Cost of Monitoring

- The determinants of monitoring revolve around the potential benefits to the bank
- The decision to monitor should depend on both the marginal benefit and the marginal cost of borrowing
- What is the variation in the cost of monitoring in the cross-section?
 - Distance
 - Complexity
 - Size
- Suggest to include and frame determinants as those affecting costs versus benefits

3b Monitoring and Relationships

- Finding: less monitoring given relationships
- Relationships are formed after/due to monitoring in the first place!
- Could it be that there is an up-front fixed cost of monitoring to set up the relationship + variable continuation cost of monitoring?
 - Check for evolution of monitoring intensity over time of a given borrower
 - Check if the effect of monitoring for newer borrowers versus older borrowers varies

Conclusion

It's a very interesting paper using unique data! I learned a lot about how banks actually monitor!

- 1 Could focus more on changes in monitoring behavior leading up to bank default
- 2 Could shed some more light on the ways of (measuring) monitoring
- 3 Frame in terms of marginal cost versus marginal benefit of monitoring