The Supply-Side Determinants of Loan Contract Strictness: Discussion & Lessons

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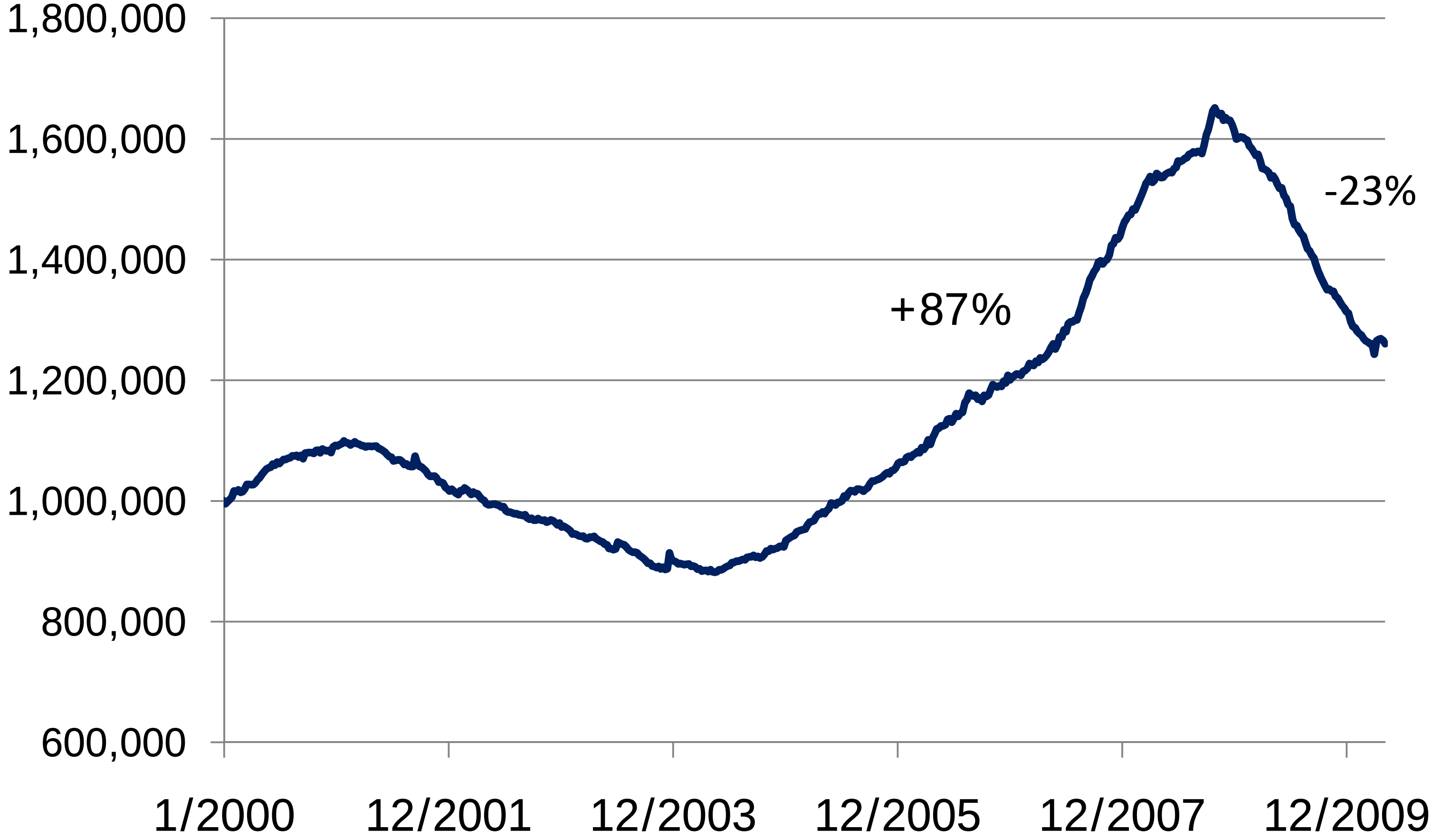
Contributions of the Paper

- New Metric: Contract Strictness
  - Price & Quantity [prior work]: Crude tools
  - Covenants: State dependent renegotiation

    "substitute ex-post monitoring for ex-ante screening"
- New Facts:
  - Bank losses → Greater contract strictness

Dramatic Drop in Lending: C&I Lending by US Banks



Dramatic Drop in Lending: Why??

- Poor Lending Environment
  - Bad economy → Fewer viable borrowers
- Shrunken Bank Capital Limits Lending
- Change in Internal Bank Decisions
  - Incentives or constraints

Contract Strictness Increases Following Bank Losses: Why?

- Declining Borrower Quality
  - Each firm is its own control (0.54)
  - Different industry & geography (0.60-0.67)
- Declining Bank Capital (0.63)
- Learning About Lender Decisions
  - Problems w/ loan officer/loan model/data
  - Larger effect if no syndicate (0.6 vs. 2.0)

Contract Strictness Increases Following Bank Losses: Why?

- Learning About Lender Decisions
- Greater Risk Aversion
  - Loan officer's asymmetric incentives
  - Regulator's asymmetric incentives
- Cycles – Only recent defaults matter

Financial covenants requiring borrowers to maintain financial ratios within pre-determined ranges were abandoned en masse during the easy credit period from 2002-2006