Banks' Specialization and Private Information

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Discussion by

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This Paper in Nutshell

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- Compare similar firms served by banks with ≠ spec. levels (+ "bank-municipality, bank-sector, bank-firm, and loan level controls")

⇒ Lower defaults and better predictions for **Micro & Small** firms for higher **Local Spec.**

⇒ Lower defaults and better predictions for **Medium & Large** firms for higher **Sector Spec.**

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Very nice paper that sheds light on novel facts about banks' specialization

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1. **Self-Selection in low default markets** - Cheap but relevant
2. **The mechanism(s) behind the results**
3. **Complementarities or Substitutability**
4. **Minor Comments**

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- Issue: banks specialize in "good" areas (low-default ex-ante)

- Suggestion: compare municipality/sector default probabilities with ***high*** and ***low*** average degree of specialization

$\Rightarrow$ No "strong relation" if selection is not too strong

Idea: avoid local factors, explain a large chunk of default probability

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Alternative:

- Natural experiments like mergers or branch closures could serve as IVs for specialization

The Mechanism(s) Behind the Results

“ **By focusing its lending activities** [...], **the bank can gather local-specific information particularly valuable for evaluating loans to the small manufacturing firm**. This includes insights into changes in demand related to house construction, supply and prices, natural disasters affecting local production, [...], and local economic downturns that can reduce consumer spending on non-essential items like furniture. ”

”Conversely, **by specializing in the manufacturing sector, the bank can acquire sector-specific information more relevant for assessing loans to the multinational company**, including technological advancements and innovations, fluctuations in raw material prices, supply chain interruptions, and changes in global economic conditions such as trade policies, tariffs, and international market dynamics. ”

” This **differentiation in the utility of local versus sector-specific information** aligns with our empirical results, **explaining how specialization benefits banks in managing loans for firms of different sizes**. ”

The Mechanism(s) Behind the Results (1/5)

Local lending specialization valuable for assessing local risk for **micro & small** firms

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1. Local Specialization relates to funding risk
    - Banks have better info in their top municipality $\Rightarrow$ lower defaults (smaller firms)
    - However, lack of diversification raises ex-ante risk and funding costs
    - Implication: $\uparrow$ local bad shock $\Rightarrow \downarrow$ lower profits $\rightarrow$ risk absorption $\rightarrow$ lower defaults smaller firm

      Spec. banks extract higher yield when hit with local-shocks, especially for firms where info is most relevant (Iyer et al. 2022)

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2. Local Specialization relates to risk taking
    - Financial booms inherently linked to risk taking, but ...
    - Soft information $\rightarrow$ specialized banks target “safer firms” (reduced risk-taking)
    - Implication: $\uparrow$ local boom $\Rightarrow \downarrow$ lower risk taking $\rightarrow$ lower defaults smaller firm

      Specialization mitigates risk taking, especially for smaller firms (Granja et al. 2022)

The Mechanism(s) Behind the Results (2/5)

- Both mechanism require information advantage
- Can you exploit differences in local or sectoral economic conditions?
- Shock types to disentangle the two channels:
  - Local climate shock or other local shock: funding risk channel dominates
  - ΔHouse Price Index: risk taking channel dominates
- Would like to see more direct evidence on the mechanism to rationalize the type dependency of information benefits

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- Suggestion: compare average update frequency across firm types and spec. levels
  - Examine *updating frequency of PDs*: **Are specialized banks updating PDS more often**?
  - **Plot AUC before/after major shocks** (e.g., COVID, local housing peak/bust)

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  - **Plot AUC before/after major shocks** (e.g., COVID, local housing peak/bust)
- Interpretation:
  - Few updates + high AUC → superior *ex-ante* screening
  - Frequent updates + improving AUC → better monitoring/learning

The Mechanism(s) Behind the Results (4/5): Guarantees

While collateralization is low in your sample, **personal guarantees are widely used**

Guarantee Shares			
	All	Micro & Small	Medium & Large
Loan Level			
Has a form of Guarantee	0.47	0.57	0.29
	(0.50)	(0.49)	(0.45)
Personal or Financial Guarantee	0.31	0.37	0.20
	(0.46)	(0.48)	(0.40)
Personal Guarantee	0.22	0.30	0.07
	(0.42)	(0.46)	(0.25)
Observations	4,945,061	3,242,692	1,702,369

- For **small firms** more **90% of personal guarantee have full loan coverage**

Do guarantees lower borrower moral hazard, or do spec. banks still discipline borrowers via pricing/monitoring (Mayordomo et al. 2017)?

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- Risk Transfer vs Information
  - *Question:* What is the **distribution of personal guarantee use for specialized lenders?**
    - If low, sign that specialized lenders have **lighter contractual terms** (*superior info*) **or** that they **specialize in types of contract** (concentrated in smaller firms)

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Would like to see more direct evidence on the connection of non-pricing strategies and information acquisition

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- Are local and sectoral specialization complementaries or substitutes?
- Does specialization work jointly with long-term relationship?
- *Suggestion*: 2×2 interaction on specialization and relationship length:
  - Interactions: *Local Spec* $\times$ *Sector Spec* and *Spec*^{j} $\times$ *Rel.Length*, with $j \in \{Local, Sector\}$
  - **Substitute**: strong performance for low spec. in sector and for short relationship
  - **Complementaries**: stronger performance when all of them are high

Minor Comments

- Systemic and Strategic Implications - Why not all banks fully specialize
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  - Explore relation with specialization and banks' level portfolio volatility – especially for local banks with greater exposure to smaller firms
- Do firms benefit from connecting to these banks?
  - Explore firms' profitability and size with specialization measures – who benefits from this?

Thank you!