

“Sorry, We're Closed”

**Loan Conditions When Bank Branches Close
and Firms Transfer to another Bank**

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Disclaimer: views are my own, not of FRS or Boston Fed

Summary

- Question:
 - What happens to loan prices when borrowing firms en masse look for new banks after their inside bank's branches close
 - Compare the evidence with the evidence for switching firms
- Why is this question important:
 - Contrast with the evidence for firms that switch individually
 - Provide additional evidence on the hold-up theories of lending relationships - especially, von Thadden (2004)
 - Welfare consequences of branch closures

Summary

- Data from Portugal that allow to corroborate the existing evidence on loans for switching firms and provide evidence for transferring firms
- Results:
 - Switchers: New loans from outside banks are cheaper than the new loans from incumbent bank to otherwise similar firms
 - Transfers: There is no such discount
- Interpretation:
 - **Since there is no discount, it must be informational cost (adverse selection)**

Outline

- Empirical predictions of von Thadden (2004) for bank closure
- Suggestions

Theory

- von Thadden (2004)'s implications for switching firms:
 - The outside banks are at information disadvantage
 - This implies a winner's curse for these banks – switching occurs only in a mixed equilibrium
- von Thadden's implications of bank closures are rich:
 - Branch closure \Rightarrow higher distance between the inside bank and its borrowers
 - Branch closure \Rightarrow elimination of the inside bank as a bidder
 - Empirical predictions are much richer and warrant closer scrutiny of the assumptions made in the paper

Theory

- Branch closure \Rightarrow higher distance between the inside bank and its borrowers
 - Higher distance is simply a higher cost of reaching the borrower
 - New equilibrium:
 - Still a mixed equilibrium with more frequent switching
 - Hence, the implication is still to expect a switching discount rather than a pooling interest rate

Theory

- Branch closure \Rightarrow elimination of the inside bank as a bidder
 - Pure strategies: only outside banks with little information bid (no winner's curse)
 - Empirical implications are richer and depend on:
 - Timing of the branch closure in the model
 - Competitive structure after the elimination of the inside bank
1. Branches are closed at $t=1$
 - Firms with short lending relationships forced to look for new banks
 - Only one inside bank: a monopoly mark-up rather than a discount
 - At least two outside banks: a pooling interest rate – the same as the firms currently pay – no discount
 2. Branches are closed at $t=2$
 - Firms with longer lending relationships forced to look for new banks
 - Their current interest rates reflect their quality but also a hold-up mark-up
 - Only one bank: pools firms but a monopoly mark-up – not clear a priori which mark-up is higher
 - At least two banks: pool firms (hold-up mark-up vanishes)
 - Good banks see higher rates, bad banks see lower rates (might not be observed econometrically)
 - On average there should be a switching discount as hold-up-mark-up vanishes

Summary of empirical predictions

	Firms with short relationships		Firms with long relationships	
	One outside bank	Min. two outside banks	One outside bank	Min. two outside banks
Inside bank vanishes	Transfer mark-up	No discount	No clear-cut	Switching discount
Inside bank is still there	Switching discount			

- The interpretation of the loss of information due to branch closures applies in the case of the firms with long relationships

Suggestions (1/2)

- Tease out the “no-discount” result by approximating the conditions under which it arises:
 - No inside bank, min. two outside banks, firms with relatively short lending relationships
- Split the firms by length of relationship with the inside banks
 - Caveat: do the outside banks observe it? I would assume so
- Branch closures leading to elimination of the inside bank as a bidder
 - Caveat: very concentrated banking system – increase the distance between the firms and branches?
- Competitive structure after the branch closure
 - Number of bidding outside banks more important than the number of branches

Suggestions (2/2)

More general questions about the branch closures as a proxy for informational loss:

- Is branch really important for business loans? What about headquarters and loan officers?
- Can we take the branch closure as a quasi-natural experiment?
 - Closed branches seem to have more loans with higher default rates but the transferring banks are much better than the average banks in the sample
- Understanding the implications of branch closures for the borrowing firms is very important given that “no-discount” result is observed only for early switchers